The Accounting Review

DECEM

the Accounting Review

Vol. XVI | DECEMBER, 1941 | No. 4

Editor: ERIC L. KOHLER. *Assistant Editors:* ARTHUR W. HANSON, and HARRY D. KERRIGAN
Published quarterly in March, June, September and December.
Entered as second class matter at the Post Office at Menasha, Wisconsin.
Manuscript and correspondence relating to editorial matters should be addressed to the Editor at Wilmette, Illinois.
Advertising and advertising inquiries and subscription and business communications should be addressed to the Secretary-Treasurer Robert L. Dixon, Jr., The School of Business, University of Chicago, Chicago, Illinois.
Subscription price: $4 a year; $1 a single copy; postage free.
Acceptance for mailing at the special rate of postage provided for in the Act of February 28, 1925, authorized February 12, 1932

CONTRIBUTORS TO THE DECEMBER ISSUE

RUSSELL BOWERS (*The Income Tax and the Natural Person*) has prepared his paper from material which originally appeared in his doctoral dissertation. He is an instructor in accounting at Port Huron (Mich.) Junior College.

CARL DEVINE (*Depreciation Policy: Repairs and Replacements*) recently secured his doctor's degree in business administration from the University of Michigan and is an instructor in accounting at the University of Kansas City.

ALEX EISENSTEIN (*Suggestions for the Content of Corporate Reports*) is a member of the staff of Seidman & Seidman, New York City, and a teacher of accounting in City College, New York.

A. C. LITTLETON (*Questions on Accounting Standards*) is professor of accounting at the University of Illinois and co-author with W. A. Paton of the Association's most recent monograph.

T. LEROY MARTIN (*Overcapitalization Has Little Meaning*) who obtained his Ph.D. degree at Harvard University in 1939, is teaching at The Bentley School of Accounting, Boston, Massachusetts. He was formerly instructor of Accounting, Washington State College, and assistant professor of Accounting, University of Wisconsin. This article is a chapter from his doctoral dissertation, *Some Economic Aspects of Corporation Accounting*.

RICHARD N. OWENS (*What is an Independent Accountant?*) is professor of Accounting and Business Administration at George Washington University, Washington, D. C.

DR SCOTT (*The Basis for Accounting Principles*) is professor of accounting at the School of Business and Public Administration, University of Missouri.

IRVING TENNER (*Difficulties of a Terminologist*) is on the staff of the Municipal Finance Officers' Association, and edited that Association's recent publication on terminology.

WILLIAM W. WERNTZ (*Current Deficiencies in Financial Statements*) is the Chief Accountant of the Securities and Exchange Commission.

The Accounting Review

Vol. XVI DECEMBER, 1941 No. 4

CURRENT DEFICIENCIES IN FINANCIAL STATEMENTS

William W. Werntz

One of the principal functions of the Securities and Exchange Commission is to make available to investors reasonably complete and accurate information about the business affairs of issuers whose securities are listed on national securities exchanges and issuers whose securities are publicly offered for sale in interstate commerce or through the mails. To this end the Securities Act requires such issuers to file with the Commission reports that are designed to furnish some of the basic information needed in appraising these securities. The Commission's examination of these filings culminates either in their becoming effective without amendment or in the issuance of a memorandum which will either cite deficiencies to be corrected by amendment of the instant filing, or note suggestions to be observed in the preparation of future filings. Failure to correct deficiencies cited may result in stop-order or delisting proceedings. These memoranda are, of course, of direct concern to the particular issuer and to the accountant who certified the financial statements involved but they have a broader import as well, since they are one of the principal mechanisms through which the Commission influences standards of accounting practice.

We have recently completed an analysis of memoranda of this type issued during the past year to about 375 companies registered under the Securities Act of 1933 or the Securities Exchange Act of 1934. This analysis, which was directed only to deficiencies or suggestions cited on the financial statements, supporting schedules, or accountants' certificate, is the subject of this paper.

We did not attempt in this analysis to differentiate "deficiencies" from "suggestions for future reports" since they were of essentially the same character, differing chiefly in the materiality of the amount involved or in the extent to which other circumstances did or did not permit the waiving of an immediate amendment. For simplicity I shall henceforth refer to both as "deficiencies." It should also be observed that all statements filed did not give rise to deficiencies. In the case of annual reports filed under the 1934 Act, about 45% elicited no deficiencies. Under the 1933 Act the proportion was considerably lower.

It is possible to classify the deficiencies cited into three broad groups: first, those resulting from violations of explicit requirements of the Commission as to the form and content of financial statements; second, those resulting from a violation of the Commission's rules governing certification by public accountants; and, third, violations of generally accepted principles of accounting or display. From our analysis the fact emerged that the great

majority of the deficiencies lay in the first category. This result was not entirely that these specific formal requirements of the Commission would be carefully observed. The nature of these departures from Commission requirements may be indicated by mentioning some of the more common ones.

As most of you will recall, Accounting Series Releases Numbers 12 and 14 announced the adoption of Regulation S–X which governs the form and content of most of the financial statements filed with the Commission for fiscal periods ending subsequent to February 28, 1940. These releases and a copy of Regulation S–X were sent to all registrants under the 1934 Act. Nevertheless, in our analysis we found that 25% of the deficiency memoranda under this Act cited a failure to observe Regulation S–X—statements being prepared in accordance with the instructions previously in force.

Another example, even more surprising, related to the schedule prescribed by Rule 12–16 which calls for the presentation of supplementary profit-and-loss information; 271 deficiencies on this schedule were cited against 172 companies, or about 45% of the companies in our sample. The most frequent deficiency stemmed from the requirement that in reporting tax expenses each significant item of taxes was to be shown separately. One hundred and five companies, or 28%, failed to observe this requirement and deficiencies had therefore to be cited. This same item of tax expense was labeled "Taxes, other than income or excess profits taxes" according to Rule 12–16, and yet 18 companies, or 5% of the total, included one or more items of income tax under this caption.

The schedule as to capital shares, required by Rule 12–14, gave rise to 74 deficiencies cited against 62 companies and in virtually all of these cases there was a similar failure to comply with explicit Commission requirements in the preparation of the schedule.

Turning to the question of balance-sheet presentation, a similar situation was found. According to Rule 5–02 of Regulation S–X, trade notes receivable and trade accounts receivable are to be separately stated in the balance sheets of commercial and industrial companies. Nevertheless, it was necessary to call this requirement to the attention of 49 registrants who had failed to observe it. Another section of this same rule requires that the basis of inventory valuation shall be given, and if valued at "cost," "market," or "cost or market whichever is lower," there shall also be given, to the extent practicable, some indication of the basis of determining "cost" or "market"; for example, "average cost" or "first-in first-out." In spite of this clear requirement there were 89 companies, 24% of those considered, who received deficiencies under this rule. It is also significant to note that the deficiencies cited under these two relatively simple and forthright provisions constituted over 40% of the deficiencies cited under Rule 5–02 which deals with the disclosure to be made in balance sheets of commercial and industrial companies.

Rule 5–03 relating to profit and loss statement presentation requires under Item 15 that there shall be separately stated the provision for (a) Federal normal income and excess profits taxes; (b) other Federal income taxes; and (c) other income taxes. These distinctions were apparently not observed by 48 companies against whom deficiencies were cited.

Rule 3–19 (c) requires that there be furnished in a footnote to the profit-and-loss statement information relative to the policies followed in accounting for fixed assets and intangibles. Yet there were 174 deficiencies cited against approximately the same number of companies because of an omission of this information

or a failure to give it clearly and adequately. Thus 45% of the companies examined were involved here.

Even the simple requirement of Rule X-2 of the General Rules and Regulations under the Securities Exchange Act of 1934 to the effect that all typing, printing and other markings be in black was not observed by 10 of the companies examined.

This enumeration does not exhaust the instances in which there was a disregard of explicit Commission regulations but it serves to illustrate some of the more frequent departures. There were many other similar deficiencies, some of them quite serious, even extending to the omission of a required balance sheet and profit-and-loss statement or of schedules supporting those financial statements.

It seems to me that this kind of deficiency ought to be easily reducible almost to the vanishing point. While we have taken the firm position that financial statements are primarily the responsibility of the management, we have not in any way lessened the joint responsibility of the accountant for them. One important function of the requirement for certification is that it should insure the review of the statements by an expert who has familiarized himself with such specific requirements as the Commission may have found it necessary to prescribe. To put it otherwise, it seems to me that in a certified statement the Commission is entitled to expect as a minimum, first that the certifying accountant is aware of such specific, positive requirements as it may be necessary to lay down, and, second, that these specific requirements have been scrupulously observed, even though the particular accountant may not be wholly in sympathy with a particular rule. If not observed, presumably the accountant is required to call attention to the departure. Where a technical deficiency of this character is found to exist, it raises some very embarrassing questions. Is the departure due to mere failure of the accountant to acquaint himself with the requirements; is it due to mere inadvertence; or did the accountant, knowing of the requirement, fail to insist upon its observance and, if so, why?

The second group of deficiencies relates to the accountant's certificate. The question of what representations and disclosures as to the audit should be made in that document has evoked a great deal of discussion over the past few years. As a result, there have been material modifications made by the profession both in the form of the certificate and in the scope of a normal audit. During the same period, the Commission reviewed its experience under the old rule and watched with great interest the proposals sponsored by the profession. Finally, last winter our rules as to certification were amended. The new rules incorporate these advances but go somewhat further in the matter of representations as to the adequacy and nature of the audit.

The new rules ask for a positive representation as to whether the audit made was in accordance with generally accepted auditing standards applicable in the circumstances. The propriety of such a requirement, as opposed to a requirement merely for a statement of the accountant's opinion on the point, was the subject of a good deal of debate and was adopted only after full consideration of opposing views. As I see it, an unqualified certificate contains an implied representation that the accountant has lived up to the standards which are generally approved by his colleagues. Such a representation, indeed, is implicit, I think, to all professions—that one who holds himself out as a professional man represents that he has and has exercised that skill and knowledge common to his calling. The new rule merely makes explicit what was before im-

plicit. To prevent the possibility that such a requirement might level practice down, it is further required that the accountant indicate whether he has omitted any procedure, whether usually followed or not, which he felt was necessary under the circumstances of the particular case. The danger of adherence to outmoded practices merely because they are customary, or of the pursuance of a "normal" program in an abnormal situation was thus recognized and, I think, overcome.

In view of the extent of these changes it was to be expected that deficiencies would occur. The frequency of these deficiencies is indicated by the fact that one-third of the certificates in the sample were deficient on one ground or another. As in the case of financial statements, the deficiencies more often related to violations of explicit requirements than to general questions of auditing practice.

In February, 1941, the American Institute of Accountants presented to the accounting profession a suggested form of accountant's certificate which would meet the requirement I have just discussed. This certificate contained the statement that:

> Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary.

Any other language responsive to the requirements is, of course, so far as we are concerned, equally acceptable. However, in spite of the publicity given to the amendment of our rules and to the suggested form of certificate developed by the Institute one deficiency memorandum out of seven noted a failure of the accountant to make these representations. Thus slightly less than half of the accountant's certificates that were deficient violated this explicit requirement.

Representations as to the adequacy of the audit, standing alone, give little information as to what actually was done. For many years, however, it has been customary to include a scope paragraph characterizing the audit in general terms. Where the certificate followed generally the form recommended in the bulletin "Examination of Financial Statements," it seemed reasonable to assume that the tenets of that bulletin had been observed, In the course of the recent discussions however there was much agitation for requiring a positive description of the work done, at least with respect to the certain procedures then being given particularly prominent mention. Although such a certificate would meet the requirements of the new rules, that philosophy is not incorporated in them. Instead, we have assumed the existence, not unwarrantedly I think, of general standards and normal procedures and have required only that departures therefrom be noted specifically, and justified. The requirement is based on the idea that departures from normal procedure are more significant than a description of the normal procedures followed and are more likely to be given the proper attention if not tucked away in a long and detailed statement of procedures undertaken.

Deficiencies cited under this rule fall into two classes—those based on a belief that there was a failure to state departures from normal procedures and those based on a disclosed departure that was not adequately justified. Cases in the first group are not numerous, since ordinarily there is no basis for belief that normal procedures have been omitted, unless a statement to that effect is made. In a few cases, however, statements made in notes or even in the certificate raised doubts that led to deficiencies. For example, in some cases it was indicated that inventories were shown "as determined by responsible officials on the basis of physical inventories." Such a

statement is not necessarily a qualification of the scope of the audit but its inclusion raises the possibility that the physical verification of inventories contemplated in the "Extensions of Auditing Procedure" may not have been observed. Such unmodified statements particularly when included in a certificate require clarification.

An amusing instance of departure from normal procedure, or at least from the usual language, was found in an accountant's certificate which contained the statement, "but we did not make an audit of the transactions for the year." A deficiency had to be cited, of course, although we were reasonably sure that the auditors intended to say that they had not made a "detailed audit." Incidentally, along this same line, there were three or four cases where the certificate covering the 1940 accounts was dated, say, March 1, 1940.

Deficiencies under this rule falling in the second group were considerably more numerous. Disclosure of omitted procedures or additional procedures furnished some basis for critical examination of the adequacy of the scope of the audit and hence gave rise to a number of deficiencies which were cited because the limitations in the audit program did not appear to be justified by the circumstances. Most of these deficiencies related to a failure to apply the "Extensions of Auditing Procedure" to receivables and inventories. While experience has not produced and probably will not produce a self-proving formula for determining when these "Extensions" are to be applied or foregone it seems clear that, in view of the breadth of the original bulletin and its supplement as to department stores, their observance is both practicable and desirable in almost all cases where the amounts involved are material. Indeed, even where internal controls appear to be adequate and effective their observance to us seems useful and necessary for their evidential value as an independent test of the operating effectiveness of the internal system. If experience indicates classes of cases where such procedures are useless or unreasonably costly, appropriate modifications of the bulletins, rather than occasional nonobservance would seem the proper course.

Deficiencies relating to the scope paragraph represented over 80% of the deficiencies cited against the certificate. The remaining deficiencies referred principally to the opinion expressed by the accountant. The opinion of the accountant as to the financial statements and the accounting principles and practices reflected therein was usually satisfactorily presented although there were a few deficiencies cited because of a failure to give a clear opinion. It was more common to find deficiencies cited for a failure to express an opinion on the propriety of significant changes in accounting principles or practices inaugurated during the year under review, or significant retroactive adjustments of accounts of prior years. According to our rules changes of this sort must be disclosed in a note to the appropriate financial statement and, if so disclosed, the accountant must give his opinion on the change in the body of his certificate. There were eleven deficiencies cited for a failure to state an opinion on such adjustments or changes.

Deficiencies of the third general category relating to the question of generally accepted principles of accounting occurred less frequently than either of the other types mentioned. Also they were less stereotyped; no specific situation occurred with great frequency.

Most often, perhaps, deficiencies of this group were concerned with the general question of income determination. A relatively common deficiency, for example, was that cited against companies

which calculated the depreciation provision chargeable to income on the basis of the cost of fixed assets in spite of the fact that these assets were being carried at appreciated amounts in the balance sheet. Depreciation on the appraisal increment in these cases was usually charged directly to the unrealized surplus resulting from the write-up, and was therefore not treated in accordance with the pronouncement of the American Institute of Accountants in their Accounting Research Bulletin No. 5. Deficiencies were cited against 10 companies on this ground.

A question of much current interest, whether extraordinary expenses or losses should be charged to earned surplus or to income, also gave rise to several deficiencies. In one case a registrant made rather substantial outlays incident to the establishment of a new retail outlet charging these costs to earned surplus. Presumptively such outlays were productive of revenue but the method of accounting employed forestalled their being shown as an offset against those revenues or any revenues and so a deficiency was cited.

In another case the registrant charged a "loss on leaseholds surrendered" to earned surplus instead of income. Such losses had consistently recurred in previous periods and had been regularly charged to income. In view of the apparently recurring character of the charge it seemed clear that its reflection in the income statement was to be preferred.

Another registrant suffered a substantial loss due to the forfeiture of deposits made on contracts for the purchase of real estate. This loss was charged to capital surplus, whereupon a deficiency was cited requiring this charge to be made against income. This case was one of the few vestiges found of the now generally rejected reasoning that "capital losses go to capital surplus." However, there remained the difficult question of whether such losses were properly chargeable to income or earned surplus. There has been an increasing tendency to regard the income statement as the single medium through which the income history of the business is to be reported rather than as a repository only for the results of purely current operations. Earning power is perhaps the most important single fact revealed by the financial statements, but to the extent losses are funneled through more than one channel the significance attaching to reported profits will be correspondingly diminished. Therefore, we have generally given particular scrutiny to any expenses or losses not reported through income. In all, there were 13 deficiencies cited because of such charges that we felt were inappropriately made to surplus.

Closely related to these cases were deficiencies cited because of improper provision for or disposition of reserve accounts. Especially was the utilization of reserves questioned when they were created by charges to earned surplus and then used to absorb losses of various kinds. Such an employment of a reserve permits losses to be detoured around the income statement with the undesirable consequences already mentioned. Deficiencies were cited against several companies on these grounds. There were also two deficiencies cited because a reserve, created out of earned surplus in a previous accounting period, was reduced and the adjustment credited to income instead of being restored to earn surplus.

In addition to questions of income determination there were a substantial number of deficiencies cited because of inadequate disclosure in the financial statements. Most common were deficiencies cited because of insufficient information in footnotes. For instance deficiencies were cited against 24 companies, or 6½% of the sample, because of a failure to note properly restrictions on corporate surplus. Usu-

ally the restriction grew out of the terms of a bond indenture, a loan agreement, or the articles of incorporation, although various other causes existed, such as the purchase of treasury stock or an excess of the liquidating value of preferred over its par or stated value. Deficiencies ordinarily involved either a failure to describe the restriction or to note the amount of surplus affected. The frequency of this type of deficiency was a little surprising in view of the usually factual character of the restriction and the general agreement that such information should be disclosed.

Another question of footnote disclosure, usually arising in connection with 1933 Act registration statements, was the extent to which events or relationships occurring subsequent to the fiscal date but prior to the date of the accountants' certificate should be reported. These deficiencies usually did not deal with events which represented a retroactive qualification of the data being presented in the financial statements. Thus, possible losses on inventories due to price declines subsequent to a balance sheet date or losses due to destruction of the plant by fire were generally provided for or noted, if significant. The deficiencies cited were largely directed to the disclosure of information that has its principal effect on future operations or future financial condition. Different approaches to this matter are possible. On the one hand there should be a proper reluctance to engage in prophecy or speculation but on the other hand there must be recognition of the fact that a principal function of historical financial reporting is to permit forecasting by others. There seems to me little question that the accountant has some responsibility for reporting events of this character; the difficulty lies in determining the proper scope of this responsibility. Balance-sheet questions raise the simpler problem. There would be fairly general agreement, I think, that such items as a proposed refinancing or quasi-reorganization should be disclosed in a footnote to the balance sheet even though approved by stockholders subsequent to the balance sheet date. Also, the effect of such refinancing on dividend or interest requirements would be indicated. The more difficult question is that of disclosure of earnings developments. The many forces that are operative in business make representations as to future profit possibilities highly precarious. Furthermore, to report unfavorable developments while omitting favorable ones might be more misleading than helpful. Nevertheless one can conceive of circumstances in which a failure to disclose significant events affecting future operations would be extremely misleading. Institution of legal proceedings that will seriously affect future profits or the loss of the major portion of the company's market may render past profits meaningless. Conversely, there is no need for reporting those minor events which are a normal part of business. The beginning and end of the accountant's responsibility in this area is not yet subject to hard and fast rules but has had to be dealt with in light of all the circumstances of a particular case. But it is equally clear that the accountant is not devoid of responsibilities.

The other principal deficiencies on the adequacy of disclosure in financial statements centered in the surplus section of the balance sheet. There were 36 deficiencies cited because of inadequacies in the disclosure of surplus. Most common was the practice of reporting a single surplus figure with no attempt to describe the type of surplus that is included, a requirement of Regulation S-X. Another fairly common deficiency was the failure to classify surplus by types when there was good reason to believe that such classification was made in the records.

This discussion by no means exhausts the deficiencies cited because of a violation

of principles of accounting or display. It does serve to indicate, however, the significance and frequency of some of the more important deficiencies of this class. In terms of frequency, although not importance, they stand in noticeable contrast with the much more numerous technical deficiencies first mentioned. The relative infrequency of these deficiencies is attributable, I believe, to two principal factors. First, and perhaps foremost, there is the requirement of certification by an independent public accountant. It is hardly to be expected that violation of well-established principles will escape his censure, and where each of two or more treatments has substantial authoritative support it is the policy under Accounting Series Release No. 4 to accept either method with appropriate disclosure, unless the Commission has previously taken a position on the question in its rules, regulations or opinions.

Second, there is the use of prefiling correspondence or conferences. Where the accounting treatment is uncertain either because no principles are well established or because there is doubt as to the weight to be given known facts it is becoming more and more usual for the registrant and its accountants to discuss the matter informally in advance of filing. Deficiencies are thus frequently avoided since a full discussion more often than not leads to agreement.

The problems that have been dealt with in these prefiling discussions are highly varied. One very important question that has occurred with some frequency has to do with the independence of the prospective accountants. A deficiency cited because of a lack of independence would be of considerable consequence to a registrant especially if the registration statement related to a proposed issurance of securities. The expense and delay entailed in securing the certification of another firm of accountants would almost certainly be serious. Discussion of the question in a prefiling conference can dispel much of this uncertainty since after a sifting of all relevant facts an informal opinion can usually be given as to whether the accountants are in fact independent.

Several questions have arisen in correspondence and conferences because of uncertainty as to principles that should govern in the realization of revenue. Under ordinary circumstances the question may present few difficulties but in unusual situations the tests of realization are sometimes obscure. Recently, for example, we have had several cases involving barter or exchange transactions. The central problem involved is the amount at which to record the acquired property and hence whether to recognize gain or loss on the property disposed of. Due to the uncertainties involved we solicited opinions from the profession as to whether gain or loss should be recognized in a case in which two unaffiliated companies effected an exchange of a large amount of marketable securities in an apparently arm's-length bargain. The opinions received, predicated on these facts, were about equally divided between those favoring a recognition of either gain or loss, those favoring recognition of neither gain nor loss, and those favoring the recognition of losses but not gains.

The extent of the differences in opinion is indicated by the arguments advanced for each possibility. Those favoring no recognition of gain or loss pointed out that the usual tests of realization were not met. Cash or a claim thereto was not received, and therefore the gain was "apparent but not real"; there had been no real change in the assets of either concern; or market quotations were considered to be an unreliable indicator of value in such a transaction. Others who favored recognition of gain or loss con-

tended that reliance on cash or a claim to cash as a test of realization was superficial since cash is merely an exchange mechanism; the chief requisite of revenue realization was held to be an arm's-length transaction and the ability to ascertain objectively and with reasonable assurance the amount of gain or loss to be reported. Those who favored taking losses but not gains felt generally that losses should be recognized on reasonably probative evidence whereas gains should only be recognized where there was objectivity comparable to the receipt of cash.

Another perplexing problem relates to a suggested method of providing for income taxes in cases where the reported financial income is materially different from the taxable income. The question has most commonly arisen in connection with bond refundings which provide a substantial tax saving in the current year due to the tax deduction for unamortized discount and redemption premiums, although for purposes of financial income reporting such discount may be amortized over later accounting periods. As a result of this difference between taxable income and financial income the current tax provision will not represent an amount related to the currently reported financial income. Therefore some companies have sought to show in their income statements an item "special charges in lieu of taxes" in an amount equal to the tax saving effected in the current year by the refunding. The credit is made to the unamortized bond discount and expense and full disclosure made in a footnote.

The reason generally advanced for the suggested treatment of tax savings is that it maintains the comparability of the financial statements by years since the reported income tax provision is not then affected by major items which are unreported in financial income. Furthermore, it is said to present the real cost of the refunding since the tax effect was undoubtedly considered and should therefore receive recognition in determining the costs to be amortized over future periods.

Objections against the practice are to my mind very weighty. For one thing this theory implies that taxable income may be broken up into several streams, each of which is taxable separately whereas in fact the tax is levied on the whole income. This introduces many difficult questions: for example, is the tax saving on a particular deduction computed on the basis of the highest tax bracket encountered, or on the overall tax rate, or on the lowest bracket; is an unprofitable department to be credited with the tax savings effected by offsetting its losses against the profits of other departments? The answers to these questions are of great significance when taxable income encounters the higher excess-profits tax rates. Also, in cases where a concern is subject to heavy excess profits taxes the management may deem it a propitious time to incur discretionary expenditures for maintenance, bonuses, advertising or the like. Few would agree that such outlays should be reported less their tax-saving effect although by implication this theory might permit it. Finally, it seems doubtful whether the theory should be relied upon as to one item such as that discussed, unless it were applied to the entire difference between tax and financial income. Yet would not doing this make the income statement a semistatistical document, rather than an accounting for operations?

To such arguments it is replied that if the adjustment is not made there will be an increase reflected in financial net income which is not due to any business improvement and may therefore be misleading. Suitable footnote disclosure, of course, might in some measure overcome this objection. However, main reliance is placed on the contention that over the life of a

corporation taxable income and financial income should be about equal, but that they may differ in any given year because tax accounting and financial accounting frequently cause profits and losses to fall in different years. Therefore, the tax provision should reflect an amount proportionate to the reported financial income. Over the years this reported tax provision would then approximate the actual tax liabilities incurred. Furthermore, the proponents of this view would see no need for applying the adjustment to expenditures for bonuses, extraordinary advertising expenses and similar charges that may be encouraged by tax considerations since these items are deducted in compiling both taxable income and financial income.

The proposition that financial income and taxable income will tend to be equal over long periods is open to serious doubt principally perhaps due to an inability to carry over losses indefinitely or to offset present losses against past profits, and to the distinction sometimes accorded capital losses and gains. Also the variation in tax rates from year to year complicates the problem of calculation. To these practical objections the answer may be given that an estimate is better than nothing at all if the underlying philosophy of the adjustment is sound. On the whole it is my present view that the income statement should usually reflect an estimate of actual taxes, plus, where income is reported, but deferred for tax purposes, as in the case of instalment sales, an estimated provision of the tax thereon. Any distorting effects due to the tax saving can, I think, be dispelled by an appropriate footnote.

Not all questions dealt with in prefiling conferences or correspondence are as controversial as these. More often it is possible to secure agreement on a particular solution as being the most appropriate. In any event, where doubt exists discussion in advance of filing seems to me the most economical and sound method of procedure and it is to be hoped that the use of prefiling discussions will tend to increase rather than diminish.

QUESTIONS ON ACCOUNTING STANDARDS

A. C. Littleton

In the preface of *An Introduction to Corporate Accounting Standards* appeared the following statement: "Because we recognize the lack of finality in what has been written, we welcome additional criticism in the interest of the further perfection of the art of keeping accounts and reporting upon them." Encouraged by that invitation friendly critics have commented freely on the monograph. On the same basis I feel sure they will welcome my attempt here to clarify some of the points they have raised.

Thus far the comments have fallen into three groups, dealing with "terminology," "income statement," and "inventory," respectively, and they are answered in that order. If these groups are fairly representative of reader reaction, the authors are getting off easily; if most of the ideas that have not been questioned are to be considered accepted by the readers, the authors can well be content.

Because part of the comment was in the form of correspondence, some direct statements of opinion have been restated here in the form of questions. For the same reason no mention is made of the source of spe-

cific questions. If the questions as stated do not clearly reflect the critic's point, the fault is mine, not his. The answers reflect only my own views and Professor Paton, my co-author, is not necessarily committed by them in any way.

TERMINOLOGY

Q. Why avoid the word "principles" and use the word "standards"? Is the word "rules" synonymous with either "principles" or "standards"? Is a "principle" inherent in the nature of the situation to which it applies; is a "standard" established by authority; is a "rule" the outgrowth of general acceptance?

A. The terms are not synonymous; each has its work to do. A rule tells how some action is to be taken. Principles touch more closely the question of why the rules are what they are. Where some important aspect of accounting theory is crystallized in a sentence, the result probably states a principle. But rules and principles do not solve the problem of concisely stating accounting ideas. I think we need standards as well because a standard is expected to provide a basis for comparing the relative desirability of several lines of action.

Perhaps the distinctions can be more clearly made by examples. *Rule:* Divide the first cost of plant by the number of years of useful life to get the periodic charge for depreciation. *Principle:* In order completely to reveal the cost of producing periodic revenue the contribution made by plant must be recognized by the periodic amortization of plant cost into expense. *Standard:* Amortize historical cost into expense in proportion to production and reserve separately for expected obsolescence. Acceptable variation from standard: Amortize historical cost over the expected useful life of the asset by combining depreciation and obsolescence. Unacceptable variation from standard: Occasionally revalue plant assets according to price-level changes and then amortize into expense.

The most useful features of the concept of accounting standards are: (1) it definitely recognizes the existence of exceptions, (2) it tries to indicate a sequence of preference among alternatives, (3) it clearly marks certain treatments as undesirable.

Q. Are standards to be unchanging like the axioms of geometry or are they susceptible to constant change and improvement? Would standards be changeable from year to year as financial expediency warranted? Would every one be freer to set his own "standards" than to establish his own "principles"?

A. Just what shall be stated as a standard, what shall be considered an acceptable variation from standard, and what shall be treated as an unacceptable variation from standard, cannot safely be decided by each individual for himself. Every man would then be a law unto himself and a selfish or short-run point of view might too often prevail. On the other hand, I doubt if standards can be "established" by authority. Rules can be so established; but standards can only be stated or phrased. Acceptance—that is, establishment—comes from usage. If standards are stated by competent bodies, after full and fair consideration of the issues, they will carry more weight with those who use them than if they were otherwise derived. But if a so-called standard seems to derive its acceptance mainly from some power that prescribes conformity, then we are dealing only with a rule even though it is otherwise named.

Finding the idea which needs formulation as a standard is itself difficult. But phrasing the thought and the variations from it is even more difficult. There will usually be less disagreement about the idea than about the phrasing and often it will be a major problem to unite rational accounting theory and customary accounting practice. But these difficulties only indicate that here is a long-time task; time and persistence can overcome all of them.

This is not only a long-time task but an unending one. Since standards are not unchanging like the axioms of geometry, a given standard is clearly susceptible to improvement in the light of later experience. There would be no acceptable basis for year-to-year change however, especially if the only reason was that of financial expediency.

Q. Is not the phrase "measured consideration" merely another way of saying "money value"? What evidence can be presented to prove that the term "measured consideration" is more appropriate than the word "value" to indicate the subject matter of accounting?

A. I do not know of any evidence that could prove one term was better than the other. I am prejudiced against the use of the word "value" in accounting because it carries with it to most readers the idea of "worth." I do not think accounting statements reflect "value" in this sense.

I am further prejudiced against the use of "value" in accounting because we cannot say "the liability is stated at a value of . . . " The subject matter of accounting gives rise to liabilities, stock equities and incomes as well as to assets and expenses. We need a term to suggest as much. "Measured consideration" may not be the best term for this purpose. Perhaps "bargained exchange" or "price-aggregate" is better. I like the last one best, but would accept any term that fits the need. The term "money value" is not very useful for close thinking. Fundamentally accounting makes records of *prices*. To say "money price" is redundant; except in the relatively few cases of barter, there is no other way of expressing price.

I am hopeful that we will some day say, whether we acquire an asset, incur an expense, and create a liability, that we are bringing into record the price-aggregate of a transaction. If the ultimate obligation of the liability is greater than this figure, adjustment can be made from time to time as the maturity date approaches. This is only the reverse of the familiar amortization of a fixed asset as it approaches its residual figure.

Q. Can accounting facts ever be verified with complete objectivity? Why say facts are more objective and more verifiable now than they used to be? Is it not closer to the truth to say that the complexity of financial and economic affairs today render objective verification more difficult than ever?

A. Modern complexities do seem to place difficulties in our path. But the complexities of forty years ago also disturbed the accountants of that day. I too am inclined to doubt the possibilities of completely objective verification of accounting facts, either for yesterday, today or tomorrow. But I am convinced that the skilled, independent auditor of today has far better techniques of objective verification than his father had before him. And I am confident that the next generation will be superior to us in like manner.

Although perfection in verification is unattainable, we can and should strive to make verification more and more objective. That is only another way of saying "make accounting less and less a matter of personal opinion, wishful thinking, or flimsy desire."

We may take heart in this matter of objective evidence from the experience of the law courts. The inability to obtain completely objective evidence does not prevent the courts from seeing that justice is done or from continually striving to obtain better objective evidence as a basis for judgment.

Q. Is it not better to hold to terminology that has already taken root in the language of accounting than to make it likely that confusion will follow attempts to introduce new terms?

A. There is a real dilemma here. If we continue to use familiar terms, confusion may arise from the fact that the words have accumulated a variety of meanings.

For example, Professor Dohr has pointed out[1] that "capital" is used in at least five different ways; "reserve" in five ways; "depreciation" in five ways. On the other hand, if we undertake to use new words, confusion may result from the fact that people concern themselves more with what they feel a word means than they do with the definition that is provided to explain it. Yet no real teacher will suggest that his students disregard the words they find but which they do not understand.

We dare not begin to discard useful words merely because some people misunderstand their accounting usage. We do not have enough terms now to differentiate adequately the distinctions we have in mind. Our apparently synonymous terms must be broken apart into distinct ideas; and we must keep single terms from being used to serve too many purposes.

We cannot afford to stop searching for useful new terms; and we must work constantly to clarify old terms. We can also take greater pains to write clearly even if we have to use a greater total of words to do so. Like the excessive use of averages, the practice of condensed writing is not all virtue.

THE INCOME STATEMENT

Q. May it not be doubted that the essential function of the balance sheet is to assist in allocating costs between the present and the future? Since each statement is useless without the other, how can the income statement be considered more important than the balance sheet?

A. As a matter of fact each statement has definite usefulness even if unsupported by another. The story each one tells can be read without the other, even though a collateral reading of the other would help to round out the details. One tells a story of capital, of solvency; the other a story of income, of earning power. Surely these disclosures are separable. True, they supplement each other; we will wish to see both. But capital is not income; income is not capital. It is not true that one statement is useless without the other. The two statements are not like the legs of a pair of pants. They are like a knife and a sharpening stone, not indispensable to each other but decidedly complementary.

If we had to do without one of these two financial statements which would you forego? If you were to choose the one which contained ideas that lie closest to the heart of business—and therefore closest to the heart of accounting—how could you possibly choose the snapshot of a moment rather than the picture of events extending over a period?

Assets are essentially deferred charges against various credit accounts. For the most part they are deferred charges against future revenues. The hope of having future revenues is the only reason for possessing assets. The use of assets to pay debts is quite secondary to their use to produce net income. That is why the balance sheet helps to allocate costs as between the present and the future. This is its essential function. It is this function alone which makes the statement useful for credit purposes.

Q. Is it not erroneous to write as if the only function of accounts was to furnish owner-manager information when there is usually a large creditor interest as well? May not the creditor interest be so compelling as to justify reporting debts payable at par and inventories at cost or market?

A. The presence of important creditor interests may bring this treatment of debts and inventories into a given report, but that does not justify the treatment as a fundamental accounting process. The creditor needs the information he desires about obligations at maturity and the course of inventory prices. In fact he needs more than this. He needs an indication of the consideration exchanged when the debt was instituted and a measure of the ap-

[1] James L. Dohr, "On the Understanding of Accounting," *Journal of Accountancy*, March, 1941.

proach toward maturity that has been accomplished, if the debt were issued at a premium or discount. He needs an indication of the cost of inventory and the amount of shrinkage if any. Under the rule of thumb of cost or market, he gets only the net figure. Accountants seem never to give creditors enough information.

Here again is the issue of choosing between alternatives. Accounts do serve creditors as well as owners; creditor interests fostered the early development of American auditing. But the fact remains notwithstanding that the function of accounts leads most directly to owner-manager data. We have only to visualize business conducted with ownership capital exclusively to see that accounting is designed to serve that situation. Accounts can serve lenders well, but if accounting had evolved primarily for that purpose it would have in it much more of "valuation" than it now has and correspondingly less of "cost," or "price-aggregates."

Q. Does not the growing tendency to stress the income statement carry with it the possibility that this statement may be emphasized to the point of misrepresenting the balance sheet? Does not devaluing plant have the effect of decreasing the depreciation charge, increasing calculated profit, and misrepresenting the balance sheet asset?

A. It takes no modern theory of the primacy of the income statement to tempt men to twist the figures in either or both statements to their advantage if they are inclined toward that sort of thing. Charging a capital expenditure to expense could be considered "misrepresenting" the balance sheet a hundred years ago as well as today.

It is not a new emphasis on the income statement that may persuade certain persons to devalue plant. It is the knowledge that an outsider cannot distinguish a necessary devaluation from a purely expedient one. It is the knowledge that the acceptable part and the excessive part of devaluation cannot be clearly separated.

Men who wish their motives to be above suspicion will be well advised to enter upon the revaluation or devaluation of assets with great caution and with an eye for dependable evidence, unless the valuing is clearly part of a bargaining process between parties enjoying complete freedom of action. In saying this, I do not want to seem to have a distrust of management. I am merely pointing out that some uncontested valuations are known to have rested upon the flimsiest foundations and that the shadow of these falls across even legitimate revaluations. An honest man with a flashlight on a dark night should act like an honest man.

Q. May not asset writedowns be in effect a quasi-reorganization entered upon by way of preventative medicine as it were? Is it necessary to wait until a deficit exists before "putting the house in order"?

A. We need not hold to original cost so tightly as to delay reorganization until a deficit exists. But can a reorganization of accounting figures accomplish much in forestalling an approaching deficit? Reorganization has to go much deeper than that far enough in fact so that the operations of the concern are altered.

The principal effect of most restatements of fixed assets is to change an anticipated series of red figures into a lump-sum red figure buried at once in surplus. If the surplus account can stand that shock, it could stand the strain of a series of negative operating results. The principal relief derived from most revaluations in a period of depression therefore is merely psychological relief. Black-ink figures seem to create much less mental strain than a succession of red-ink figures do. Thus going from one color to the other may seem like making progress even though the total shock to surplus or total drift toward a deficit in the future is not changed at all.

Management would be well advised to resist as long as possible the notion that "changing values" are throwing the accounts out of date. Original costs, viewed in the light of supplementary, nonaccounting data of the moment, are a more dependable basis for managerial decisions than changes in price levels can be. Reorganization can indeed serve as preventative medicine. But it should not be prescribed too soon or too often. And when it is used, the dosage should be closely regulated by a realistic judgment of probable long-run conditions rather than by a hopeful view of the short-run.

Q. What is the distinction between earned income and realized profit in the same period? Does the income statement reflect one or both?

A. Some of the results of a fiscal period may derive from utilizing the assets in productive activities. This is "earning an income." Some of the results may represent nothing more than the outcome of giving up rather than utilizing a productive asset. This is "realizing a profit."

We have been calling one report an income statement for so long that we forget its ancestor used to be called a profit-and-loss statement. The importance of knowing the figure for recurring income from operations has tended to lead us into an excessive separation of earned income and realized profits. We should preserve the distinction of course, but report the items together. Full disclosure of the results of management's stewardship requires that income and profit be reported in such a manner as to minimize the possibility that the latter may be overlooked by the reader. This is particularly important when nonoperating loss is present at the same time as operating income.

It is significant in this connection that recent discussions have favored combining the income statement and the surplus analysis into a single integrated statement. The object is to help the reader avoid losing sight of clearly related figures. But it is equally important that the statement shall not fall into such a form as may obscure the income figure representing earning power. It would be grossly misleading if the inclusion of nonoperating elements should give the impression of violent fluctuations in recurring earning power.

Q. Should adjustment of depreciation for prior years be reported in the income statement? Should capital gains be credited to income or to surplus? Should not a clear distinction be made between gains from carrying on a business and gains made from the sale of a part of the enterprise?

A. The instruments of production and the products of industry are clearly distinct, and the net credit derived from the disposition of each has a different origin. That difference in origin should not be obscured in the accounts. Yet a strong element of similarity remains to hold the two credits in blood relationship. That fact also must be kept in view. If a capital gain is reported in a surplus schedule, that relationship may escape notice. The phrase "profits available for dividends" still has vitality even though the phrase "recurring earning power" falls much more often upon our ears.

We need to recall that the idea of capital gains and capital losses is not what it used to be. We have come to recognize that depreciation adjustments and a profit or loss from the sale of depreciable property are undoubtedly related. We see now that real capital gains and losses derive only from the sale of land or investment securities. The idea is not as useful as it once was that surplus represented past profits and that surplus therefore had to be adjusted for errors in prior calculations. Another idea is coming to the front, namely, that it should be possible to see the figures for earned income and realized profit as they accumulate over the years. If some losses and all adjustments can be buried in a separate

surplus analysis, the continuing series of profit-and-loss statements fails to achieve some of its purpose.

Q. Is it a violation of accounting principle to debit an asset and credit earned income for the accretion due to natural growth? Is it not inconsistent to report interest as earned without it being realized and yet decline to show income as earned when the productive process is complete?

A. The deep forces that produce favorable or unfavorable results are too diverse for actual measurement. Yet we must continue to seek evidence which will help us to know when recognition may be given to profit or loss.

For manufactured goods sold for cash the evidence that income is present is considered conclusive; for manufactured goods sold on credit the evidence is still strong but it is not as convincing as if the cash had been collected; for manufactured goods unsold the element of doubt is so increased that we decline to report a profit.

On the other hand, when one morning we find spring lambs in the pasture, we may be so impressed with nature's bounty as to believe that the evidence is convincing. Today we have animals that yesterday we did not have; realization, we feel, could never be more real. Yet the hazards of cold weather, the risks of the market, the lack of outside confirmation that these physical facts are also financial facts: these thoughts may make us hesitate to say that the natural increases are any more than promising potentialities of profit. If new figures are brought into the accounts on that basis, the best one could do would be to use them to express deferred income. Again, when we look at a surplus from appraisal of fixed assets our doubt of the evidence is such that many of us decline even to see a deferred profit there.

Interest is a very peculiar institution. It should not color our thinking on other matters too much. We are not bound to apply interest-ideas to operating accounts.

Q. Are the cyclical profits that are involved when cost of sales is stated at original cost, unreal profits and hence elements to be removed bodily in the calculation of net income, or are these profits real enough from present transactions but subject to dissipation by later losses on other transactions?

A. I am inclined to favor the second view. Accounting deals with measurement in terms of transaction units and time units; it is policy-making that deals with desires and objectives. As soon as we shift our eyes away from measurement to policy we begin to drift off the accountancy pavement.

Profits from present transactions must be measured by accounting methods. Evidence may indicate that these profits may be dissipated by later transactions. But that opinion cannot change the present fact. The assets just obtained from present transactions were accepted as assets in these exchanges. The profit aspect of the same assets goes with them. There is nothing unreal about the asset received as the difference between original cost and selling price. It may be unwise to pay all such profits out as dividends. But the act is unwise not because the present profit is unreal, but because it is conservative first to see what the immediate future may bring (by way of asset loss or higher purchase prices) before we reduce our assets extensively by unreturnable dividend distributions.

In accounting we must set an end to every transaction. We must have fiscal periods. The accounting notion of profit is inescapably colored by the necessity for periodic figures and by our inability to do accounting work except transaction by transaction. I doubt that there is such a thing as cyclical profit distinct from noncyclical profit. Although profit may sometimes originate in managerial efficiency and sometimes in economic scarcity, we cannot transfer the refinements of economic theory to accounting measurements.

INVENTORIES

Q. Do the authors oppose the proposition that expenditures originally regarded as costs should be recognized as losses and immediately written off or made the subject of a reserve when it appears that the original cost will prove not recoverable?

A. The best response to this inventory question is probably to say that one sentence in a summary at the head of a chapter cannot reveal the authors' views as successfully as two pages of text.

The real problem is not whether cost remains too long as the asset. Rather, when is original cost to be considered proven as not recoverable? The evidence supporting nonrecoverability will be varied; sometimes it may be irrefutable, again only convincing or suggestive; or it may only vaguely hint at a possibility. The disposal of asset cost should rest upon a consideration of all the available evidence and upon a close judgment of the quality of that evidence.

The question mentions two alternatives, writing off and creating a reserve. The alternatives are not identical. Repricing inventory sheets is not the same thing as "writing off" since the debit will be classified differently. A reserve created by a debit to profit and loss is not the same as a write-off since its basis is different. There is even a place for a simple parenthesis informing the reader of the balance sheet of a price fact in addition to the original cost of the inventory. In fact, if there is no evidence to support an inventory adjustment except a decline in repurchase prices, such a parenthesis is a clear disclosure.

Q. Why does not the same reasoning that supports reduction of inventory for damaged or obsolete goods also support a write-off because of a fall in prices?

A. Damage and obsolescence is acceptable as a reason for adjusting the inventory not because inventory is "less valuable" but because an irrevocable loss has occurred. Price declines for goods we have not bought does not create for us an irrevocable loss. Price fall may be a warning of losses to come; but so long as a given price trend is reversible, as it always is, the loss in goods on hand is not yet very convincing.

An asserted permanent reduction in value from price fall is also unconvincing. The only permanent aspect of market price movements is that of change. When goods have been sold for less than their cost we are convincingly faced with an accomplished fact. Short of that stage we are dealing only with probabilities or possibilities. In accounting we cannot always wait for the accomplished fact; the accountant, like the physician, must at times work with probabilities. But we should work with them in a different manner than with accomplished facts. To write down inventory in the same way for goods that have been destroyed by water and goods for which duplicates could be obtained at a lower price, is not a very good demonstration of refinement in technique. Instead of this sounding like unimportant hair-splitting, I hope it may sound like an invitation for accountants to demonstrate to a critical public that accounting can refine its techniques.

Q. After all, a judgment that goods are partially obsolete is only a subjective opinion of loss in value, whereas a fall in market price is objective evidence that the goods will have to be sold in the near future at a loss.

A. I would want better evidence for any write-off, obsolescence included, than unsupported subjective opinion. Judgment there must be in dealing with business and accounting matters. But judgment in my opinion is a wise choosing among alternatives.

Data for market price changes are probably easier to obtain than facts about obsolescence. But data that are easy to find in print are not made objective thereby.

Prices that represent transactions wholly outside of our own acts cannot be objective for us; they can only indicate the current actions of others. The action of others may contain a warning to us, but they are not our actions. Data showing that obsolescence is present are harder to get but, if available, they are convincing.

Evidence of goods obsolescence can be (1) conclusive (substitute goods available and actually being taken by customers in preference to our goods), (2) persuasive (mere presence of goods that could be used as substitutes), (3) inadequate (opinion that substitutes may soon appear, or that goods now available may presently fall from popular favor). One situation may therefore call for immediate removal of the items from inventory; another calls for no more than creation of a reserve; inadequate evidence of loss calls for no action at the moment. The same kind of reasoning applies to damaged goods. But price changes for others' transactions can hardly constitute conclusive or even persuasive evidence of actual loss in our unsold goods.

Q. Is there any essential distinction between these two situations: (1) a new type of product appears on the market making it necessary for us to sell inventory items below our original cost price; (2) a declaration of peace releases new supplies of our type of product making it necessary for us to follow the market price down, and sell below our original cost price?

A. If write-off is to follow upon a fall in probably realizable value from any and all causes, there is no need even to attempt to distinguish the two situations. But the reverse is probably nearer the truth; that is, it is difficult to distinguish two such forces, so we decline to frame a rule to cover both.

Both situations may indeed force us finally to sell below original cost. But so too could a managerial decision to sell below cost in order to divert business from a competitor. If that decision is reached in May to be put in effect in June, should not the inventory of May 31 be written down? The fact of lower realizable value is less significant than the cause for expecting a loss to occur.

There are difficulties involved in trying to attach specific causes to particular effects. Nevertheless the best clues to accounting treatment lie in the causes and sources of transactions. Accounting theory should direct us wherever possible to distinguish differing causes and varieties of sources. Whether professional practice shall follow or ignore theory in a given case is of course the prerogative of the professional accountant. I hold no brief for prescribing his action. I only urge that his actions reflect deliberation upon the alternatives and that his decision result from conscious intellectual effort rather than from some rule of thumb.

Q. Do cost factors, in fact, move through a business in procession like a file of soldiers as seems implied in the first-in, first-out base? Is not first-in, first-out the one method above all others tending to emphasize distortion of financial statements resulting from changes in price levels?

A. Figures of speech appearing in the midst of an attempt to write of technicalities very easily catch the critic's eye. Obviously "like a file of soldiers" is a figure of speech when applied to cost factors moving through the accounts. Not every nut has a number; yet one of the lot does reach its bolt before another. One barrel of crude oil does reach the refinery before the next barrel in the pipe line even though we cannot see where one barrel-measure ends and the next begins.

In attempting to formulate accounting standards it is advisable to build the standard about the usual situation rather than about the unusual. In most lines of business goods are identifiable and it is advisable for many reasons to move the oldest goods first. This establishes the norm which should be expressed in the standard. Businesses where the goods are not identifiable

by units merely present a theoretical exception to the characteristic pattern. Those situations therefore could hardly generate anything more than an exception to the standard.

"Distortion" is one of those troublesome words. I hope that someone will some day try his hand at telling us how we can determine what distorts and why.

Q. If the rule of cost or market is repudiated, is that not equivalent to repudiating the principle of conservatism?

A. At best conservatism is a creditor's rule based on the theory that a prospective borrower is likely to understate his obligations and overstate his assets. A banker who was not conservative would get few deposits to lend to other people. But the surveyor employed to mark the boundary of certain property, is not expected to be conservative, only accurate.

It will be an advantage to accountancy if accountants will think of themselves as technicians in certain kinds of measurements. They can do this with advantage even though all of their measurements fall short of being as perfect as one could wish. The engineer never forgets, no matter how delicate his micrometer may be, that his work is correct only within limits.

Repudiation of the cost-or-market rule rests more upon doubts regarding the theories that underly it than upon its relation or lack of relation to conservatism. Here are the underlying theories: (1) that a conservative view is reflected by overstating the cost of goods sold through lowering the prices of inventory items; (2) that a fall in repurchase prices is adequate evidence that a loss will result when sales will have finally been made; (3) that adjustments of inventory must be made through individual items rather than against the aggregate; (4) that probable losses should be anticipated by a profit-and-loss charge before a loss has taken place.

There is something to be said for some of these theories if taken separately. But viewed as a whole, as they must be viewed with reference to this inventory rule, they produce a foundation that is not convincing.

Q. Is it sufficient to regard conservatism as something for parentheses or for interpretation, rather than a principle of accountig itself?

A. The implication does not express the attitude of the monograph authors. A careful appraisal of the monograph as a whole will be unlikely to leave the typical reader with a conviction that the authors have such a passion for great theoretical precision that it leads them to favor sacrificing reasonable prudence.

Accounting is measurement, and precision must be characteristic of measurement. Ideal precision is not attainable in accounting any more than in engineering. There are degrees of precision. Honing the cylinders of an inexpensive motor to a clearance of .015 inch does not set the standard or precision for a pursuit ship's motor. A greater degree of precision can be accomplished in accounting than that obtained from a rule of thumb like cost or market. Accounting will always lack complete precision; but its precision of measurement can always be improved.

The facts of business are not more complex than the facts of engineering. Why then do we hear so much about a conservative accountant and so little about a conservative engineer? Is it because the engineer is understood to be able to work within varying degrees of precision but the accountant is assumed to work always within the precision of $.01? If a bridge engineer does undertake to lean toward conservatism, it will be by means of a safety factor added after his calculations have been made of the stresses to be expected. He does not try to calculate stresses "conservatively."

There is a way of expressing conservatism in accounting. But it is not by way of repricing items in the inventory lists.

Q. Would you reject a writedown of inventory if wild and unsuccessful speculation had left management loaded with high priced materials on a rapidly falling market?

A. Such situations try men's souls as well as place a strain on accounting principles. The main problem here is to determine how much to adjust the inventory. Is it sufficient to write down to closing markets or reserve that much? I very much doubt it. The underlying issue is whether the concern is solvent. Now solvency is a legal concept and not one from accountancy; and a creditor is not going to judge the safety of his debt solely on current market price. A present margin of solvency now may easily disappear with the next move of prices.

How far can financial statements go in picturing solvency? Shall original costs be the basis of the statements, or shall liquidation values? I know that liquidation values are not sufficiently within the realm of accounting facts to have a place in a balance sheet. And I know that the use of original cost will give the impression to some that the maker of the balance sheet is trying to say that the cost figure is the value of the inventory. But I do not believe this is a fair interpretation of cost in the balance sheet. Cost is the starting point of every calculation of loss or gain. That is what a cost-inventory is, a starting point. The figure for cost should not be concealed by reporting only an adjusted figure. Let the interested parties know all the facts: original cost as well as cost adjusted for possible losses interpreted out of falling prices. If the word "writedown" in the question permits concealment of the cost facts, I reject it even for unsuccessful speculation. If the phrase throws the anticipated loss into cost of sales, I reject it again.

Q. Do the income-tax regulations require repricing of individual items in the inventory and thus interfere with the use of a reserve against the aggregate inventory?

A. I suspect that the familiar preference of accountants for cost or market as the rule for treating individual items in the inventory sheets has long ago been lodged in the regulations of the Bureau of Internal Revenue to the prejudice of an aggregate method. If the alternative for the taxpayer would have been inventories at cost with no tax reduction until the goods were sold, I can easily imagine that he would favor taking whatever losses he could get recognized. But the denial by a tax rule of a reserve treatment of inventory aggregates is not proof that all factors justifiably affecting inventories will have been covered by the rule. There should be more behind inventory adjustment than replacement-price changes.

At the same time I can imagine that the tax administration is not likely to favor allowances for inventory reserves that may be whatever anyone may wish them to be. There should be an ascertainable basis for estimating inventory reserves; it should require that numerous factors be give specific consideration. When and if that is done, the result will be a better determination of net income for tax or any other purposes, than that which must result from the application of an ancient, overgeneralized rule of thumb. There was a time when the Bureau of Internal Revenue would not accept an estimated allowance for bad debts. What considerations changed that attitude? Could the same type of reasoning be advanced for inventory shrinkages? But accountants will need to make up ther own minds before they can hope to influence others.

THE BASIS FOR ACCOUNTING PRINCIPLES

DR SCOTT

THE concept of a government of law as contrasted with a government of men is one of the best expressions of the role of principles in human affairs. However, this familiar legal dictum refers to a highly specialized application of principles. It assumes a systematized body of law which applies only to those relations between human beings (as individuals or groups) which are regulated by the authority of a politically organized society.

Back of any such system of law lie general principles which were formulated so early in the evolution of human society that we cannot determine their origins. These general conceptions or principles serve as standards for the judgment of human conduct. Some of them are justice, fairness, truth, kindness, friendliness and beauty. There are many of them. They are so general in character that they defy exact definition.

Systems of law and types of government come and go; the things which men believe to be just and beautiful change, but these general conceptions persist from age to age. They give a continuity and stability to human society in spite of its violent upheavals and in spite of the spectacular careers of many individuals who flout them with apparent impunity.

These abstract, generalized conceptions have no formal or official relationship to each other. Nevertheless they do serve different functions and tend to supplement each other.

Those spheres of action which we designate as government and law are concerned with such problems as the administration of community interests; the assessment of various responsibilities, and the adjudication of overt conflcts of interests. They are dominated by the concept of justice.

The concept of beauty has for its special province the field of the fine arts in all of their ramifications.

Religion has tended to devote itself to the kindlier and more personal conceptions which go beyond the precise and rigid requirements of justice and of law.

For the present generation of Western peoples at least, the most pervasive and most unifying of all principles is that of truth.

The extent to which truth and justice prevail in human affairs is not due to any supernatural influence of the particular things which men at any given time believe to be true and just. Neither is it due to any magic inherent in those abstract conceptions of truth and justice. It is determined rather by the decisions and actions of men in the concrete process of living. Abstract conceptions are valid and significant only as they express and interpret the concrete experience from which they are drawn. Indeed in the most fundamental sense they remain part of that experience.

When we undertake to study modern society we soon realize that it could not be what it is without the current body of abstract scientific knowledge. That body of knowledge is an impersonal, matter of fact, integral part of current society. In other words it has the character of concrete reality.

Theory is a sort of distilled essence of practical experience. It is a guide to practice only in the sense that it reconciles practice with itself and so helps to integrate concrete social processes.

A tendency to integrate theory with

practice; principles with action, and abstractions with concrete social processes is a characteristic current feature of Western civilization. It is implicit in the doctrine of relativity of modern science. It explains why accountants, along with many other professional groups, are seeking to orient themselves to underlying principles.

Because of the relations with which it deals, accounting is most directly concerned with the principle of justice. In this respect it is like law and government.

The many accounting rules which have grown out of practical business and accounting experience are continually changing with the changing conditions under which business enterprise is carried on. In some fields government agencies have set up specific requirements covering accounting procedures. However, in general we depend upon a more flexible method of social control over accounting practice. The members of an officially recognized profession are given authority to certify that accounts have been kept in accordance with accepted principles and practice without any legal or governmental definition of what constitute accepted principles or practice. Thus the responsibility of determining what rules and procedures are acceptable is placed squarely on the shoulders of the accounting profession.

The allocation of this professional responsibility is implicit rather than by direct commission. The usual requirement of both practical experience and the passing of a technical examination by those who are admitted to practice as certified public accountants, indicates a standard for the profession in terms of both technical knowledge and the judgment which comes from experience. However, it should be noted that these qualities are merely the qualifications for participation in the task of determining what rules and practices are acceptable. They do not constitute the basis for such determination.The actual basis of determination reaches back to the principles underlying social organization. Without such a connection, we would achieve only a personal government by accountants rather than a regime of law or principles administered by the accounting profession.

General statements relating accounting rules and procedures to underlying social principles might well be called accounting principles. They are none the less real on account of the fact that they have not been given specific formulation. The most important of them might well be stated as follows:

The procedures, rules and techniques of accounting must afford equitable treatment of all interests actually and potentially involved in the financial situations covered by accounts.

This statement applies the general principle of justice to the accounting field. Hence the propriety of its designation as an accounting principle. It underlies such accounting decisions as the adoption of an accrual basis of accounts; the treatment of credit sales as income, and the treatment of depreciation as an operating expense. It is the fundamental basis for the accrual of all incomes and expenses and the distinction between charges to assets and those to expenses. It is the tacitly accepted standard which checks and shapes the evolution of accounting tradition and the development of accounting rules of thumb. Any rule of thumb which consistently fails to meet it will in time be modified or discarded by common consent.

This principle of justice is the cornerstone, so to speak, of accounting theory and accounting practice.

The principle of truth also applies to accounts. It may be stated as follows:

The accounting record and summary reports drawn from it should present a true and accurate statement of the information which they purport to record and present. Accounts

must not be made a means of misrepresentation.

It was stated above that in our present culture the principle of truth has a broader application than the principle of justice. Nevertheless, the practical application of the principle of truth is subordinate to the foregoing application of the principle of justice. Accounts must not be made an instrument of misrepresentation, not because there is a law against lying and not because lying is immoral. That ethical problem lies outside of the field of accounting. Accounts must avoid misrepresentation because of its effect upon interests concerned in the data presented. Misrepresentation involves an inevitable violation of the principle of justice.

In their practical application of the principle of truth accountants must avoid taking a narrow and meticulous attitude. They must remember that truth is relative and that every statement of fact is only a partial truth. Take for example the problem of contingent liabilities. Every business enterprise is confronted at all times with numerous adverse contingencies. If the accountant were to insist upon a meticulous statement of all of them in the balance sheet, the effect would be to exaggerate their importance and give an erroneous impression to a reader of the balance sheet. In deciding what contingencies to include and how to present them the accountant must sometimes base his decision upon the total impression which will be conveyed rather than upon grounds of a narrow meticulous accuracy.

At the time when modern accounting was developing in the trading field, many of the modern methods of accounting control were unknown. Present day techniques of appraising receivables had not been invented; current methods of stock control were yet to be devised; the use of statistical data from past operations was unheard of, and even the depreciation of fixed assets was not treated as an operating expense. Under those primitive conditions the doctrine of conservatism became firmly established in accounting. It did not come in as a principle in its own right but rather as a practical rule subordinate to the general principle of truth in the accounting record and accounting statements.

Unfortunately tradition has glossed over the circumstances under which the doctrine of conservatism arose. Many accountants have come to accept it as a principle in its own right. When so accepted it ceases to serve its original function of supplementing or implementing the principle of truth. Instead it contradicts the principle of truth and brings confusion into the counsels of the profession.

Accounting rules, procedures and techniques should be fair, unbiased and impartial. They should not serve a special interest.

This might be called the principle of fairness. Its character as a supplement to the principle of justice is obvious. It appears in accounting discussions most often as an insistence that given accounting results shall be arrived at objectively.

Accounting rules, procedures and techniques must be continuously revised to allow for changing economic relations in order that they may continue to embody the principles of justice, fairness and truth.

The history of accounting has been one of continuous development of both theory and technique. The process must continue for the reason that economic relations constitute one aspect of a general process of social evolution. The necessity for adaptation arises from the fact of change which is a universal characteristic of both social and physical phenomena.

However, the principle of adaptation is always subordinate to the three principles previously stated. Its limited character is clearly indicated by reference to the following principle with which it always should be associated.

Accounting rules, procedures and techniques should be consistently applied. They should never be changed arbitrarily to serve the temporary purposes of management. When changes are necessary they should be controlled by the principles of justice, fairness and truth.

Consistency and adaptation are both necessary in accounting in spite of the fact that they tend to contradict each other. If we accord them the rank of principles, they clearly are principles of a less general order than are justice, fairness and truth.

It follows from the principle of adaptation that accountants should be tolerant and open-minded in their appraisal of new accounting methods and procedures. The appraisal should not run in terms of conformity with convention but rather on the basis of whether or not the proposed methods or procedures are in harmony with fundamental principles. It follows also that in a time of rapid change in economic relations the rate of change in accounting rules and methods must be equally rapid.

Innovations in accounting typically appear in practice rather than in formulated rules or theory. The need for them arises in concrete situations. It is created by specific problems. Under the pressure of circumstances practice goes ahead of theory but it typically is bad practice. It is likely to be bad practice both in the sense that it violates accepted conventions and in the sense that it violates the principles of fairness and justice. When variations in practice arise out of the pressure of particular situations not all the interests involved are likely to be equally well represented by the authority which passes on the necessity and form of the variations. Hence a biased application of the new method or procedure and injustice are likely to result.

Accounting at the present time affords an excellent example of the process of evolution here described. It illustrates both misuse of a new method on the part of business management and a short-sighted opposition to it by accounting theorists. The method in question is the statistical method.

This is an age which is characterized by large-scale operations and the use of mechanized equipment. The use of quantity production methods in the field of economic production has brought in its wake the adoption of like methods in the field of selling or distribution. Successful applications of mechanization and a coordinated specialization to peaceful industrial and business activities have led to their application to military operations with startling results. Both private business administration and public administration have been compelled to adjust themselves to the dominant trend toward large-scale operations, the mechanization of processes and a general standardization of administrative routines.

In this development of large-scale business enterprise under a regime of machine process, the individual business transaction typically has ceased to be a contractual meeting of minds of free agents in an open market. It has become merely one of a large class of actions which, on one side at least, are shaped by general policies. The determination of policies and the general administration of big business have come to run in terms broader than the individual transaction.

Of course the administration of large-scale operations must have a record of and maintain control over individual transactions along with other details of operations. In fact big business is even more dependent than little business upon a precise use of records and a precise control of details. And its more rigid requirements in this respect are slowly bringing about, as a general transformation of business records, the bad practice in accounting which is referred to here.

Current evolution in business records

has two distinct aspects. The lesser of them is a constantly increasing use of mechanical equipment in the keeping and interpretation of records. The other is a matter of attitude in the treatment of the data involved. In part it is merely a question of dealing with large masses of data but it is more than that. It is a subordination of the record of individual business transaction; to the broad purposes of accounts. It is essentially an application of the statistical method to accounting data.

The statistical point of view is not new in accounting but neither is it generally accepted by accountants. It has been adopted by practically all accountants for the purpose of calculating depreciation expense. It is generally accepted by cost accountants up to the point of the incorporation of the results of cost accounting into summary accounting reports but even cost accountants do not as a rule insist upon carrying application of the viewpoint to its logical conclusion in the summary presentation of accounting data.

There are many points in accounting theory and practice at which the question whether or not to apply the statistical point of view is a current issue. One of them is the problem of bad-debt expense.

Many accountants take the position that the bad-debt cost of any fiscal period is the volume of accounts which have proved to be bad and have been marked off the books during the period. An opposing position is that the proper bad-debt expense of any period is a statistically calculated percentage of the sales of that period. The calculation of such a percentage is based upon previous experience with bad accounts.

Strict application of the first position would preclude the use of an allowance or reserve for bad debts. However a compromise procedure permits the building up of a reasonable reserve based upon statistical interpretation of past experience and thereafter the treatment of bad accounts written off as the periodic expense. Of course the writing off of accounts must follow a definite policy for otherwise there would be no objective determination of the amounts to be written off each year. Also the reserve will be set up by a charge to earned surplus. In the application of this compromise procedure the statistical method may be used also to spread bad-debt expense over monthly operating statements even when accounts marked off are used as the expense in the annual statement.

The issue raised by these alternative procedures is essentially the question whether or not a statistically allocated cost shall be accepted as the accounting measure of bad-debt expense. It is one of many problems which raise the question whether accounting should preserve its traditional emphasis upon the individual business transaction.

Some accountants advocate the deduction of bad debts from gross sales along with trade discounts, returned sales and other special allowances but such treatment does not materially change the problem here under consideration.

In support of the use of accounts marked off as bad-debt expense it may be argued that typically the customer's inability to pay his account develops after the sale is made to him and his account is written on the books; that the cost arises through his becoming unable to pay and that the loss so incurred should be treated as an expense of the period when it is recognized.

On the other hand it may be argued that every credit sale involves an element of risk. No credit department can be infallible or omniscient. The management of every enterprise which sells on credit knows in advance the risk involved and a properly calculated appraisal of that risk is an expense to be charged against the sales of each fiscal period. To illustrate this argu-

ment more precisely, let us assume a company which discontinued one of its products two years ago. In the current year an account which arose through sales of the discontinued product is found to be uncollectible and is marked off the books. Is the loss suffered thereby a proper charge against current sales of the products which are still being made and sold? Or is it a cost which should have been charged against the income from the product which has been discontinued?

The issue here raised is a specific example of the general problem of "matching" costs and incomes. And that general problem is to be solved not by appeal to practice or tradition but only by appeal to the above stated principles of fairness and justice.

In the matter of production costs we have in practice reached the point of agreement that the manufacturing costs of goods sold in a given period should be matched against the sales of the period. We do not recognize the cost of manufacturing operations of the period as a proper deduction from the net sales of goods. But with regard to selling costs and more general financial and administrative expenses there is not the same unanimity of views. Some accountants are disposed to insist that general administrative costs should be divided between production costs and distribution costs and that distribution costs should be allocated or matched against net sales in a fashion parallel to the treatment of manufacturing costs. However, more conservative practice still allocates selling and general administrative costs to the fiscal period directly and thereby accomplishes an indirect matching of them against sales income. The essential difference involved is that the indirect matching makes a maximum use of conventional accounting methods and a minimum use of statistical processes.

There are many costs whose financial incidence is irregular. If the management takes out insurance against such costs we spread the insurance premiums over the periods covered by them. The insurance company assumes the risk of such costs or losses and the cost to the insurer is reduced to a contractual basis in the insurance policy.

However, not all costs whose financial incidence is irregular can be covered by insurance and sometimes business management elects to carry risks which could be covered by insurance. In either case the question arises whether the proper charge against periodic income is the regular distribution of risk or the irregular loss in the periods when it occurs.

It already has been stated in this discussion that business operations on a large scale have tended to minimize the importance of individual transactions. Thereby they have discounted the value of so-called actual costs. Policies tend to run in terms of average costs and hence for purposes of managerial policy average costs are the actual costs.

Large-scale operations necessitate a continuous, effective managerial control and management in turn demands a continuous and regular accounting control in precise terms. Current pressure thus runs strongly in the direction of a greater regularization of costs and incomes. With a generally accepted pattern like the Reserve for Depreciation before them, business managements have shown a readiness to set up many different types of reserves whose purpose has been to regularize costs. Often this has been done when accounting practice afforded no adequate basis or method by which to achieve the desired regularization. In the absence of an effective method which would control the practice, its application has been shaped by managerial discretion. The result is that instead of making accounts a more accurate and useful tool of management, the practice has

become a means whereby, sometimes unconsciously and sometimes consciously, management has manipulated its accounts.

At this point we might well moralize by pointing out that whenever management prostitutes accounts by making them serve its particular ends, it loses the objective, disinterested service which is the greatest contribution of acccounting to management.

Another and no less important question to consider here is the attitude of accountants towards the attempts of management to regularize costs and incomes.

The effect of a standardization of costs typically is a tendency to equalize profits. In the absence of a proper basis for the standardization of costs, managements sometimes have made mere equalization of profits the controlling purpose rather than an incidental result of legitimate standardization. The consequence has been a natural reaction among accountant against both the standardization of costs and the equalization of profits when those results are achieved through departures from conventional methods and procedures of accounting.

While this attitude on the part of many accountants is readily understandable, it has tended to obstruct the orderly development of accounting technique. It is as short-sighted as the view of the management which undermines the objectivity and impersonal character of the accounts upon which management is so dependent.

New accounting methods are not bad merely because they tend to equalize profits as compared with the results obtained by conventional accounting practices. Neither are they bad because they provide a matching of costs and incomes which is more useful to management. They are to be judged fairly upon the basis of such principles as those cited earlier in this discussion. The accountant should not be hasty in his criticism of management or reactionary in his demand for faithful observance of accounting conventions. He should rather take a constructive attitude and try to develop accounting technique which will enable management to obtain the desired results without undermining the objectivity of accounts or impairing the validity of their results.

The most recent statement of principles published by the Executive Committee of the American Accounting Association includes as point four under the section on income the following statement:

"Income should not be distorted or artificially stabilized by creating arbitrary reserves either by appropriating income or surplus or by overstating expenses in certain periods and subsequently charging to such reserves expenses and losses pertaining to succeeding periods. Earned surplus reserved for contingencies or for similar purposes does not lose its character as earned surplus; expenses or losses arising from contingencies thus anticipated should be reflected not as reductions of the reserve but in the income statement of the period in which they are recognized."

This statement does not effectively meet the problem which is involved. The question begging terms "distorted" and "artificially stabilized" serve only to obscure the issue. No accountant and no honest management wants to distort income or show in one period expenses which belong in another period. The question a tissue is the proper determination or accrual of expense. A specific illustration will help to make this clear. If a large company elects to carry its own fire insurance and makes periodic additions to a Fire-Insurance Reserve based on the statistical data underlying fire-insurance premiums, should the periodic allowances be treated as so many appropriations of earned surplus to a contingent reserve or should they be treated as expenses of the periods in which they are added to the contingent reserve?

It is not clear from the above quoted passage whether or not it would sanction charging bad accounts marked off and fire losses to reserves set up for those specific purposes. However the supporting comments include the following statement: "This comment does not apply to operating reserves created by meeans of carefully determined charges to current operating expenses."

This latter statement appears to give approval to the statistical determination of such costs as Bad-Debt Expense and Fire-Insurance Expense. In fact it appears to be a general commitment to the use of statistical methods of cost determination for the proper use of statistical processes insures not only their careful determination but also an objective and impersonal determination.

We all accept the doctrine of consistency. We agree that accounts of different periods should be kept on a comparable basis. But what is to be the test of comparableness? Is it to be a statistically achieved comparableness of results or is it to be a consistent use of traditional accounting interpreted as essentially a record of individual transactions?

From the point of view of the management of large-scale enterprise under a regime of machine processes, the answer to the above question of distortion is clear. The need of such management is for a statistical comparableness in accounts. The significant cost is the ever present risk and the distortion occurs when we treat the fire loss as the cost. For managerial purposes the only pertinent question is how to arrive at a periodic measure of the effective cost and at the same time preserve the objectivity, independence, fairness and justice of the accounting procedure andits results. To this latter question the answer is an appeal to statistical methods of determining costs. Only by the adoption of such methods will accounting adjust itself to the institutional change in business practice whereby the administration of large business enterprise runs in terms of general policies rather than in terms of isolated individual transactions.

An address by F. P. Byerly published in the August 1937 *Journal of Accountancy* included the following comment: "... What has frequently been spoken of as accounting principles includes a conglomeration of accounting practices, procedures, policies, methods and conventions relating to the construction of accounts and their presentation. . . ."

Unfortunately this statement is true. The elevation of mere rules and conventions to the status of principles tends to bring rigidity into accounting practice and into the thinking of accountants about practical problems. It tends to destroy the open-minded tolerance and initiative with which rules, procedures and techniques should be adapted to meet the changing problems of business enterprise. And the effect of this error is aggravated when principles are assumed to have a coercive character such as was ascribed to them in the prize-winning essay of Gilbert R. Byrne published in the November 1937 *Journal of Accountancy*.

According to the currently accepted philosophy of science, not even the broadest generalizations of the physical sciences are coercive in character. The so-called laws of science are merely tentative generalizations subject always to revision upon the basis of further evidence. The popular statement that we have learned to control nature through the means of modern scientific knowledge is not true. We have in fact merely learned about the phenomena of our physical environment and our actions have been shaped by that knowledge. The veritable miracles which have resulted from modern science have come from our learning to swim with the current in our relations with the physical world and not

through our acquiring control over it in any fundamental sense.

The social sciences look upon society and social phenomena as part of the objective universe in which we all live. They assume that we can study our social environment from the same point of view that we use in studying our physical environment. They undertake to formulate dependable generalizations which will shape our conduct relative to our social environment in a way that is comparable to the influence of the generalizations of the physical and biological sciences in our relations to our physical environment. Their degree of success will depend upon the reliability or objective validity of their generalizations.

Many persons are ready to affirm in advance that this task of the social sciences is impossible and others are discouraged by the slow progress made by the social sciences. However that progress does not appear so slow if we compare it with the early histories of the physical and biological sciences instead of contrasting it with their present accomplishments.

The conception of accounting as a branch of the social sciences is of more practical significance than may at first appear. The committee on terminology of the American Institute presents a definition which describes accounting as an art. This definition is misleading. It gives only a partial and distorted characterization.

Accounting is not an art in the sense that we use the term in referring to the fine arts. It is not an art in the sense that it is a type of work which calls for manual dexterity. It is an art only in the same general sense that the practice of law or the practice of medicine is an art. If we were to say that law is an art we would be accurate only in so far as we referred to the practice of law. We would be ignoring the science of jurisprudence and the study of law as an integral part of human society.

To say that accounting is an art limits our definition to the practice of accounting. Accounting is also a science in the same sense that law, government and economics are sciences. It can achieve the objective validity which we so much wish for it only in the same way that they can achieve objective validity. And it is only as accounting realizes the status of a science that in it the principle of truth transcends the principle of justice. There is no easy road to accounting salvation. If we expect to realize an objective validity for accounting by setting up a system of easy rules to which we can all subscribe, we shall be making an even worse mistake than the would-be musician who undertakes to master the piano in ten easy lessons by correspondence.

DIFFICULTIES OF A TERMINOLOGIST

Irving Tenner

The writer recently discussed the handling of municipal expenditures in the operating statements with an official of a large city. Complete agreement was not reached until the official was asked to define "expenditures" and we discovered we had not been talking about the same thing. This incident illustrates the value of a common terminology, particularly its importance in written communication. For in conversation, if it is not clear what the speaker means, we can question him, but a reader cannot do this. Not only has the value of uniform terminology long been recognized but even the necessity of preparing concise definitions and present-

ing them in a compilation as one of the means of achieving uniformity is well established.

There are two principal classes of terminologies: those prepared for general use and those related to a particular publication. General dictionaries (e.g., *Webster's New International Dictionary*) and the terminologies of the American Institute of Accountants and the Dominion Society of Chartered Accountants are examples of the first class. The definitions given in the accounting publications of the Federal Power Commission and the National Association of Railroad and Utilities Commissioners, or in statutes are examples of the second. In the latter glossaries, it is usually pointed out that the terms are being defined in the sense in which used in the particular publication or statute. The terms may or may not be generally accepted.

The first step in the preparation of a terminology is to determine to which of the classes it belongs. This step is directly related to the next, the selection of terms. If the compilation is limited to a publication, the choice is simple; if not, many problems arise. A terminology like that of the National Committee on Municipal Accounting presents even greater problems because it represents a combination of both classes. It is intended for general use but it is also tied in directly with the Committee's publications. The problem of selection is made more difficult by the fact that municipal accounting comes in contact with many other fields: private accounting[1] —or more specifically, general, cost, institutional, and utility accounting—public administration, public finance, and law.

There is no doubt concerning some of the terms in each field. For example, there is no question about the necessity of including definitions of "assets" and "liabilities" (general private accounting), "standard cost" and "cost unit" (cost accounting), "endowment fund" and "grant" (institutional accounting), "operating income" and "clearing account" (utility accounting), "budget" and "budgetary control" (public administration), "assessed valuation" and "tax" (public finance), and "ordinance" and "municipal corporation" (law). On the other hand, definitions of "capital stock," "paid-up capital," or "parent company" must, quite clearly, be excluded. The difficulty arises in determining whether terms like "leasehold," "fractional assessment," or "authentication" belong in the compilation.

Again, the municipal-accounting field itself contains a great number of terms but most of them do not present problems. None questions the necessity of defining such a word as "fund"; there is also no doubt about the exlcusion of self-explanatory terms such as "fund balance sheet."[2] Similarly, words which designate undesirable accounting practices should be excluded. For instance capital surplus should not be defined, since the Committee recommends against the offsetting of fixed assets by bonds and calling the difference "capital surplus." Finally, definitions of account titles should ordinarily be excluded if the broad class to which the particular account belongs has been defined, e.g., ordinarily the account title "accrued interest receivable" need not be defined if the definition of the term "accrued assets" is given. Difficulty arises in determining whether account titles not covered by general definitions, or financial statements and records, should be defined.

[1] Of course there is no such thing as a purely accounting term because accounting provides for the recording, interpretation, and presentation of financial data and the accounting terms therefore have reference to the financial transactions for which the accounting is made. Nevertheless, we can single out some terms which may be said to be peculiar to accounting, e.g., assets, liabilities, and surplus, in that they are exhibited in the principal financial statements.

[2] Provided it is stated to be "the balance sheet of a fund" and both "fund" and "balance sheet" are defined.

No general formula for the selection of terms can be given. As far as those terms taken from fields other than municipal accounting are concerned, their degree of relationship to municipal accounting as exemplified by the frequency of their use in this field should determine their selection. In the case of municipal accounting terms, the usefulness of the particular word and the possibility that the concept may not be subject to brief definition must be kept in mind. For instance, if the terminology relates to a particular publication in which financial statements are exhibited, it should not be necessary to define each statement, (1) because it is difficult to define a particular financial statement briefly, and (2) because the individual statements can be examined. The definition is particularly unnecessary if the statements, in addition to being exhibited, are described.

The third step, definition, offers a series of problems. In defining a word one may make use first of all of his own experience; e.g., if a person has examined hundreds of tax rolls he can generalize his experience with respect to them in a definition. However, the compiler must also rely on other sources. In preparing a municipal accounting terminology, for instance, he may have to examine municipal financial reports, statutes, published legal requirements of governmental agencies (e.g., the classification of accounts of the Federal Power Commission), court decisions, textbooks, monographs and other treatises, compiled terminologies of such bodies as the American Institute of Accounts, and general dictionaries.

It is well known that definitions from various sources frequently conflict; a few examples may be cited. "Budget" is sometimes used to designate an estimate of proposed expenditures for a given period or purpose and the means of financing them, and sometimes it is used in the sense of a budget document, that is, as the instrument used by the budget-making authority to present a comprehensive financial program to the appropriating body. "Municipal" occasionally designates a city, town, or village, and sometimes any governmental unit below or subordinate to the state. In some financial reports colloquial expressions are substituted for generally accepted terms: "city's alimony" for "city's taxes," "tax fi fas" for "tax liens," "cold check" for a check dishonored by a bank for insufficient funds, "tax duplicate" or "grand list" for "tax roll," "ratables" for "taxable property," and "operations fund," "general purposes fund," "current fund," or "corporate fund" for "general fund."

Although bonds are commonly understood to be instruments under seal, Mississippi statutes say that "the word 'bond' shall embrace every written undertaking for the payment of money . . . whether it be sealed or unsealed. . . .[3] Taxes are commonly considered delinquent when a penalty for nonpayment attaches. In Virginia, however, they are designated delinquent by statute some time after the penalty for nonpayment is attached. The Federal Power Commission and most public service commissions, contrary to common procedure in commercial accounting, exclude depreciation and taxes from operating expenses. The New York State Public Service Commission requires this treatment of depreciation and taxes by water utilities but municipal electric utilities are required to include depreciation as part of operating expenses. Some courts have defined an appropriation as the setting aside of a designated sum of money for a particular purpose, which is in substance the generally accepted definition of a fund. Readers acquainted with accounting literature know that prepaid expenses and deferred charges are defined synonymously by some

[3] Code of Mississippi 1930, §1365.

authors but not by others; that the term "reserve" is limited by some to segregations of surplus, whereas others include in this group accounts set up to show reductions in accounts, e.g., a reserve for depreciation or for bad debts.

Sometimes, too, a term is used both in a narrow and a broad sense. For example, "accrue" is defined in the broad sense of the accrual basis, namely, "to record revenues when earned or when levies are made, and to record expenditures as soon as they result in liabilities . . . " and also in a narrow sense to denote "the recording of revenues earned but not yet due and the recording of expenditures which result in liabilities that are payable in another accounting period."

In some cases, it is possible to pick out one of the many conflicting definitions, whereas in others it is necessary to give all the existing definitions for a particular term. The determining factor is the frequency with which the defintions are used. The terminologist must consider himself a reporter, not an inventor. If he were an inventor, he might set up a terminology all his own, consisting preferably of terms not in everyday use and not employed in any other field. The terminology would consist of words, which like the algebraic symbol, "x" and "y" would have only those meanings arbitrarily assigned to them. But these artificially created titles would find little use. Language, whether general or technical, is the product of gradual development based on common usage and cannot be artificially superimposed. The compiler of a terminology in a special field must, like the compiler of a general dictionary, describe what he finds.

If words are defined differently in various fields related to the field under consideration, the definition used in each field should be given. To illustrate, public finance and municipal law are, as previously indicated, related to municipal accounting. Two definitions of "legal opinion" must be given: one in the sense in which employed in municipal law, namely, "the opinion of an official authorized to render it, such as an attorney general or city attorney, as to legality" and the other in the sense in which it is applied to municipal bonds, i.e., "the opinion, usually of a specialized bond attorney, as to the legality of a bond issue."

Even within the same field it may be necessary to give several definitions for one term, if they are commonly so used. One example is, as shown before, the use of "accrue" both in the narrow and broad sense. Another is the definition of a warrant both as "an order drawn by the legislative body or an officer of a governmental unit upon its treasurer directing the latter to pay a specified amount to the person named or to the bearer" and as "an order for the treasurer to receive money." Still another is the use of a word both as a noun and as a verb, e.g., the use of "levy" as a noun, to denote the total of taxes or special assessments imposed by a governmental unit or as a verb to indicate the imposition of taxes or special assessments.

If one term is used more frequently than another, that term should be included in the terminology. Thus "assessment" is defined by some as a compulsory charge levied by a governmental unit for the purpose of financing services performed for the common benefit; by others, as the process of making the official valuation of property for the purpose of taxation. The latter meaning is, however, the one most frequently assigned to this title and should be employed by the terminologist. Another factor is the use of the term in other definitions. If "assessment" is made synonymous with "tax," then a tax roll becomes an assessment roll and the compiler must determine the frequency with which "tax roll" and "assessment roll" are employed.

In the above examples, one title cov-

ered several definitions but the same principles apply to instances in which several titles cover one definition. Here, too, frequency of use should be the governing factor. For instance, if most textbooks, statutes, and financial reports designate the document showing the assessed value, tax rate, and amount of tax levied against particular pieces of property, a "tax roll" but in a small number of financial reports it is called a "grand list" or "list of ratables," the compiler should select the title "tax roll." If "grand list" or "list of ratables" is used in quite a few cases, he may indicate following the definition of "tax roll," that the titles "grand list" or "list of ratables" are sometimes used synonymously with "tax roll." If, however, these variations are found in only a few isolated instances, they need not even be mentioned.

If two titles are employed with about the same frequency, that title should be selected which best describes the characteristics of the definition. For instance, if "current fund" and "general fund" are both in common use, the compiler should choose "general fund" because it more nearly indicates a fund available for any legally authorized purpose than does "current fund." But he should also call attention to the synonymous term.

Finally, some of the apparent conflicts are upon analysis found to be immaterial or nonexistent. For instance, the use of a definition in a different sense in some other field need not be taken into account, if it has no relationship to the field under consideration. Thus a fund in commercial accounting designates a sum of money or other assets whereas in municipal accounting it is also considered an independent accounting entity. Since, however, the commercial-accounting definition does not affect municipal accounting, the term needs to be defined only from the point of view of municipal accounting. Sometimes an apparent conflict disappears when it is found that one of the definitions represents a special application. To illustrate: in one case the court in substance defined "appraisal" as a valuation or an estimation of value of property by two disinterested persons of suitable qualifications.[4] This definition is in conflict with the commonly accepted one ("a valuation of property"). However, actually there is no conflict because the court is not defining "appraisal" but "impartial appraisal."

Sometimes, too, terms are assumed to conflict if the addition of an adjective to a word completely changes its meaning. It is not possible, for example, to derive the meaning of "revenue bond" from the definitions of "revenue" and "bond." A revenue bond is not a bond paid out of the revenues of a municipality but a bond the principal of and interest on which are to be paid solely from earnings, usually those of a municipally owned utility or other public-service enterprise the revenues and sometimes the properties of which are pledged for this purpose. Similarly, an assessment and a special assessment are two different things. An assessment refers to a tax base; a special assessment to a special tax. In each case, an entirely new definition is created; and it need not contain elements of each of the words which go to make it up.

The next important step is to determine the limits of the definition, that is, how many of the characteristics and peculiarities of the term should be considered. A terminology should be presented from a definite point of view; for instance, the National Committee's terminology, as already indicated, is stated from the point of view of municipal accounting. This does not imply that terms should always be restricted to municipal accounting. To illustrate, if an audit program is described as a detailed outline of work to be done and the

[4] Magin v. Niner, 110 Md. 299, 304 (1909).

procedure to be followed in any given *governmental* audit, the descripton is restricted to governments. An audit program is equally applicable to government and business and the restriction should be removed by eliminating "governmental." Where, however, the definition conflicts with the description of a similar term in another field, the word must be understood to be defined in the sense in which used in municipal accounting, e.g., the definition of "fund," already referred to.

Even assuming that a term is to be restricted to municipal accounting, the question still is: To what extent shall the definition be broadened? The object is to make a definition as concise as possible; at the same time if too general, it is likely to lose its usefulness. The desirable goal lies somewhere between the extremes of a too general and too restricted definition. Usefulness is, again, the guiding factor. To illustrate, the broadest definition of a municipal bond is "A document evidencing indebtedness by the municipality." Although the definition covers all municipal bonds without exception, it is not a useful one. It does not describe the characteristics of a municipal bond, namely, that the indebtedness is of a fixed amount, payable at a fixed time in the future and bearing interest, usually payable periodically and that the document may not be under seal but generally is. If the description is to cover these characteristics, it should read as follows: "A written promise, generally under seal, to pay a specified sum of money called the face value, at a fixed time in the future, called the date of maturity, and carrying interest at a fixed rate, usually payable periodically." Two of the characteristics, namely, the requirement that the promise be under seal and the periodical payment of interest, it will be noted, do not always apply. But they usually do and this fact is made known by the insertion of "usually" or "generally." The term is then limited to the usual cases, which is precisely what a working definition should do.

On the other hand, a word should not be defined in such detail that large and important classes of transactions are excluded. If an assessment roll is stated to be "an official list showing the assessed valuation of each parcel of taxable real property in the assessment district, with descriptions of properties and names of all known owners, and the assessed valuation of taxable personal property for each owner thereof," it is made inapplicable to many assessment rolls: (1) In some jurisdictions property exempt from taxation, such as church property, is also assessed and show on the roll. (2) Since real property taxes are frequently levied against the property and not against the owner, the names of owners are not shown on the assessment rolls of many governments. Moreover the only important fact to know is that the assessment roll is the document in which the assessed values are listed. The definition should preferably read as follows: "The official list showing the description and the assessed valuation of each parcel of real property and of other property for each owner thereof." If it were usual to list names of property owners, the phrase "*usually* also the names of all known owners" would be inserted after "real property."

Although the definition should describe all of the usual characteristics, it should be in concise form, preferably in one or two sentences. Those descriptions which do not form an essential part of the definition should be carried in a note. For instance, expenses are said to be "charges incurred, whether paid or unpaid, for operation, maintenance, and interest, and other charges which are presumed to benefit the current fiscal period." It is important, in addition, to warn the reader that in practice legal provisions sometimes make it

necessary to treat as expenses charges whose benefits extend over future periods. Since, however, the definition can be understood without knowing this fact, the latter can be explained in a note. A definition must be complete without the note; that is, the information in the note should be such that its removal will not affect the validity of the definition.

In selecting and defining words one must recognize the other terms in the particular terminology. Sometimes a word must be defined even if it is not directly related to the particular field provided it is used in the definitions of other terms in the field. For example, the word "bond" is not particularly significant in municipal accounting but it must be explained in order that the term "bonded debt," "bond anticipation notes," "bond discount," "bond fund," and "bond premium" may be readily understood. Defining "bond" in one place obviates the necessity of doing the same in each of the foregoing definitions. It should be particularly noted that if a word is already defined in the terminology the full explanation need not be repeated in connection with the description of another term. For example, in a terminology in which investments are explained as "securities, in which money is invested either temporarily or permenently," investments in default are improperly defined as "securities in which money is invested either temporarily or permanently and on which there exists a default in the payment of principal or interest," because the definition of investments is repeated. The proper explanation is "Investments (q.v.) on which there exists a default in the payment of principal or interest."

Similarly, if an adjective does not change the definition completely (contrary to the case of "assessment" and "special assessment" cited before), the full definition of the term being modified need not be given. For instance, in defining "delinquent taxes," it is not necessary to repeat the definition of taxes but merely to point out that delinquent taxes are "taxes (q.v.) remaining unpaid. . . . " Suppose, however, that taxes need not be defined except in connection with delinquent taxes. Would it be desirable, in that case, to set up a separate definition of taxes and then to proceed to define delinquent as "taxes (q.v.) remaining unpaid . . . " or should the definition of taxes be included in the definition of delinquent taxes making the explanation read "compulsory charges levied by a governmental unit . . . remaining unpaid . . . "? The answer will depend on whether the inclusion of the full definition of another term within the definition makes the latter cumbersome. For instance in the case of "tax deed," the term "tax" should be set out separately because if the full definition of taxes were included in the definition of "tax deed" the description would be as follows: "A written instrument under seal by which title to property sold for compulsory charges levied by a governmental unit for the purpose of financing services performed for the common benefit (not including specific charges made against particular persons or property for current or permanent benefits and privileges accruing only to those paying such charges as licenses, permits, and special assessments) is transferred unconditionally to the purchaser." Contrast this definition with the following, "A written instrument under seal by which title to property sold for taxes (q.v.) is transferred unconditionally to the purchaser."

No special terms should be included in the definition unless they are explained somewhere in the terminology but there is no point in explaining words whose meaning is generally understood. For instance, in a definition of "actuarial basis" it is not necessary to explain the meaning of "basis" and the definition may therefore begin with this word, e.g., "A basis used . . . . "

A definition may be made clearer by contrasting it with another one. For example, the definitions of a resolution and an ordinance are more meaningful when contrasted. An ordinance is defined as "a bylaw of a municipality, enacted by the council or governing body as a local law," and a resolution, as "a special or temporary order of a legislative body." By indicating that the difference between an ordinance and a resolution is that the latter requires less legal formality and that ordinarily the statutes or charter will specify or imply which action must be taken by ordinance and all other action may be by resolution, the definitions are further clarified. Similarly the description of direct expenses as "those expenses which can be charged directly as a part of the cost of a product or service, or of a department or operating unit" is further clarified by adding "as distinguished from overhead and other indirect costs which must be prorated among several products or services, or departments or operating units."

Attention should be called to any confusion of terms which may exist in practice. Thus public accounting is sometimes confused with governmental accounting, although the two are different, public accounting referring to the practice of accounting for various enterprises which stand to the accountant in the relation of client rather than employer, and governmental accounting, to the preparation, reporting, and interpretation of accounts of governmental bodies. It is therefore necessary to add after the definition of the former: "The term is not synonymous with 'governmental accounting.'" Similarly since a loan fund, that is, a fund whose principal is loaned to qualified beneficiaries, and when repaid is loaned again to others, is likely to be confused with a bond fund, which is a fund established to receive and disburse the proceeds of a governmental bond issue, it is essential to add after the definition of "loan fund": "The term should not be consuded with 'bond fund.'" Again if a title is likely to imply nonexistent characteristics, the compiler should indicate that such implication is erroneous. For example, the definition of an independent auditor as one who is independent of the executive head of the governmental unit whose accounts are being audited, is not complete. It must also be pointed out that the term does not apply to an auditor who is merely independent of the department being audited.

All of the complements of a term should be given; if "receipts" are defined, so must be "disbursements," and if a definition of "preaudit" is given, a "postaudit" must also be defined. Sometimes, though, a word may be defined and not its complement, e.g., "operating expenses" are sometimes used to describe expenses for general government purposes but the complementary term "operating revenues" is seldom used to describe the general revenues of a governmental unit.

As far as possible the corresponding opposite title should be selected: If "revenue" is defined, "expenditures" should be given as its opposite; if "receipts" is used, "disbursements" should be defined as its opposite. Distinguishing further between receipts, if "revenue receipts" and "nonrevenue receipts" are selected for definition, the complementary words "expenditure disbursements" and "nonexpenditure disbursements" must be chosen. Common usage, however, may call for the selection of a term other than the opposite one. For example, the opposite of "internal audit" is "external audit." But in practice "independent audit" is used more frequently than "external audit";[5] therefore, "inde-

[5] There is also theoretical justification for the common use of "independent" rather than "external," especially if we relate the definition to the auditor instead of to the audit. For the term "external auditor" implies that the auditor cannot be a member of the governmental unit audited, whereas actually he may be a

pendent audit" should be defined. "External audit" should also be listed and cross-referenced to "independent audit" but need not be defined. The opposite of "long-term budget" is "short-term budget." Yet "current budget" or "current-year budget" are the terms commonly used to designate the budget prepared for a short period of time such as a year, and must be selected for definition.

Sometimes, too, an adjective is implied. For instance, the definition of "municipal bond," previously cited, is in reality a description of a municipal corporate bond but the term "bond," unless otherwise qualified, is understood to refer to a corporate bond. If another type of bond is described an adjective must be added. Thus, if a surety bond is defined, the full title, "surety bond" must be given. Again, "book value" is frequently understood to mean "net book value"; that is, book value after deducting the related reserve for depreciation or other valuation reserve.

The foregoing should not be confused with overlapping definitions. Thus the term "preaudit" does not mean "administrative preaudit" as is sometimes assumed; for example, the term is occasionally defined as "an administrative examination for the purpose of determining the propriety of proposed financial transactions and of financial transactions which have already taken place but have not yet been recorded." As far as "preaudit" is concerned, the description is valid but it is erroneous in attempting to define also an administrative audit. Although most preauditing is by administrative officials, it may be performed by independent auditors. Accordingly, "administrative" should be taken out or "usually" inserted before "an administrative."

If possible, a term should be defined positively, not negatively. For example, the definition of the general fund as "the fund that is not restricted to any special use. . . ." is negative; it tells us what the fund is not. It should be stated positively as "the fund that is available for any legally authorized purpose." Similarly, the negative definition of "public authority" as "a public agency which does not levy and collect taxes or assessments but can charge tolls or fees for a service rendered . . . " should be changed to designate "a public agency . . . which is financed from tolls or fees charged those using the facilities operated by the agency. . . ."

Another important error to watch out for is the use of the term being defined in the definition itself. For instance, the explanation of the direct debt of a municipality as the debt owed directly by the municipality is obviously not very helpful. The direct debt is properly defined as the debt which a governmental unit has incurred in its own name or assumed through the annexation of territory.

A word should be defined in the singular, unless it is commonly used in the plural. The definition of the singular is likely to be more clear-cut. "Expenditures" and "proprietary accounts" are examples of terms commonly used in the plural.

Cross-references should be made between related terms. References should not only be made to words used in the definition which are defined elsewhere in the terminology but also to other related terms. For instance following the definition of "preaudit" there should be a reference to "postaudit" even though no mention is made of the latter word in the definition of the former.

A terminology must be reexamined from time to time because continual changes in practive may necessitate changes in old terms and addition of new ones. For example, formerly special assessments were limited to the financing of improvements but now they are also used to finance such

member of such unit providing he is independent of the executive head.

services as street lighting and the definition of "special assessment" has been broadened correspondingly. Again, capital budgeting is a more or less recent development; consequently the definition of "capital budget" is relatively new. Finally, due to the changing financial relationships between state and local governments modifications are already being recognized as necessary in the definition of "shared state taxes."

THE INCOME TAX AND THE NATURAL PERSON

RUSSELL BOWERS

THE intent of the Sixteenth Amendment (1913) was to delegate power to the Federal government to levy a tax on the income of natural persons. An income tax on corporations had been effective four years before the amendment (1909–1913). It was decided as early as 1904 that an excise tax could be measured by (gross) income,[1] and a corporate income tax was construed to be an excise tax for the privilege of doing business as a corporate entity.[2]

Whatever might have been the intent of the amendment or the popular belief, the income tax has not developed into a personal tax in a strict sense either in law or in other respects. The present Federal income tax is unique in the sense that it cannot be classed with any other known form.[3] From a legal standpoint the tax does not follow the person. From an economic standpoint it does not fall on persons in proportion to their respective economic circumstances. It is neither legally nor otherwise a personal tax based on ability to pay. The various statutes, interpretations of the courts, and administrative rulings describe the tax in terms of sources from which income is derived. In so doing the unified status of the economic circumstances of the individual is frequently not apparent. Thus the effectiveness of graduated rates is stultified.

The Supreme Court did not take a personal concept of income in the case of United States v. Phellis when it held a corporative dividend realized by the stockholder is taxable income.[4] The stockholder might have bought the stock immediately before the dividend was declared at a cost which might or might not have included the value of the dividend. Yet the court said the purchaser merely "stepped into the shoes" of the vendor. Even though "presumably the prospect of a dividend influenced the price paid" and it was "discounted by the prospect of an income tax to be paid thereon," this is a strange reliance upon the process of discounting and surely presumes a greater knowledge of future market and tax conditions by those engaged in market operations than actually exists. The error

[1] Spreckels Sugar Refining Co. v. McClain 192 U. S. 397.

[2] Flint v. Stone Tracy Co., 220 U. S. 108 (1911). Before the Amendment the Constitution required that taxes levied on persons by the federal government must be apportioned among the states according to population. A personal income tax passed in 1894 was declared unconstitutional because it violated this condition. (Pollock v. Farmers' Loan and Trust Co., 158 U. S. 601). The earlier federal income tax laws (1863–1872) expired by their own terms without their validity being challenged in the courts.

[3] See Brown, Robert C., "The Nature of the Income Tax," 17 *Minn. Law Rev.* 127.

[4] United States v. Phellis, 257 U. S. 156 (1921).

of the court, if it is an error, might have been less noticeable under the then prevailing rates than under the present steeply graduated individual income-tax rates. Under graduated rates the equitable shifting of an income tax is a practical impossibility.

The Natural Person and the Corporation. The corporation interpreted as a person, artificial though it may be, may lead to an inequitable tax. While the corporation itself is a legal person, it is owned by natural persons. Consider a man who carries out productive activities in the name of a corporation. Surely he would raise special objection to taxing the corporate income at his own individual tax rates, and then, in withdrawing a dividend from this separate entity, to paying a tax again on his own income. This man would believe in the separate corporate entity for some purposes but not for others. In at least one case on record an exchange of securities between a corporation and its sole stockholder produced taxable income.[5]

The importance of the corporation as a type of business entity is everywhere apparent, but in terms of the more fundamental purposes of economic activity the natural person is more significant. If economic activity has as its ultimate goal the satisfaction of man's wants, corporate activity cannot be an end in itself. The efficacy of the corporation lies in a form of business enterprise which contributes to a more effective means of creating and distributing economic goods.

It cannot be denied that the separate entity view of the corporation is satisfactory for some purposes. The corporate form has been found effective for receiving funds, investing them in economic resources, converting and utilizing these in the creation of marketable products, and finally in allocating the monetary proceeds to individuals according to legal and equitable principles of private ownership. If the management and the investors are divorced, the situation is of no concern to the major economic purpose of the undertaking. If the investors themselves do not manage, it is to their interest to employ others who do. All that a corporation has is invested from without. Corporate earnings are not an exception; these are investments of the stockholders. Since everything a corporation has is owned by somebody external to the enterprise it can have no net worth. Not all it owes is a legal liability, but all that it owns is offset by a legally recognized equity of a natural person.[6]

In early times a natural man was the unit around which productive activity centered. Historically when accounting reports became necessary the most important aspect was the preparation of a statement showing the adequacy of a man's property to satisfy the claims of his creditors. The man was worth the difference between his assets and his liabilities, and this was quite an important thing in his economic life. But if one tries to transplant this conception to the modern corporation, as is so often done, the absurdity should be apparent. A natural man's habits of consumption are conditioned largely by his income and net worth. A corporation has no habits of consumption. No matter what may be the legal view, the corporation can never be a person in some respects. The corporation is no more than an economic agent. It sows, reaps, and gathers into barns, but having been granted perpetual life and endowed with completely altruistic

[5] Burnet v. Commonwealth Improvement Co., 287 U. S. 415.

[6] Professor Irving Fisher has expressed such a view in his distinction between accounting of *real* persons and *fictitious* persons: *The Nature of Capital and Income*, p. 92.

motives, it need take no thought of its own future. The limitations of the entity view are scarcely anywhere more evident than in the case of income taxes under graduated rates.

In general this philosophy of the corporation points toward a greater emphasis on the similarity of the items which compose the right side of the corporate balance sheet. Even if the line of demarcation between legal liabilities and the other items could be sharply drawn, as in fact it cannot be, the many varieties of stock still justify a denial of the category "net worth" and "proprietorship" of a corporation. A stockholder is not a proprietor in the traditional sense of the word. He is little more of a proprietor than is a bondholder. Both are investors in a coöperative enterprise which for some purposes is a separate entity.[7] A stockholder has very few of the rights and provileges enjoyed by the traditional proprietor. It seems forced to speak of the stockholders collectively as proprietors. Nor are stockholders like partners; there is perhaps more of an analogy between stockholders and bondholders than there is between stockholders and partners. It is not, of course, to be denied that the unfavorable relationship of corporate liabilities to the residual claims may drive the enterprise into receivership. The distinction between the two kinds of equity is sometimes a vital one in law and there are vital economic questions involved; but these are to be subordinated when it comes to the relationship existing between the corporate entity and all corporate investors.

The form of double taxation which taxes first the income of a corporation and then again the remainder upon distribution is a form of double taxation which might well be eliminated from the tax structure. Is it not true that an income tax on a corporation as if it were a taxable entity similar to a natural person is based on false premises? Would anybody argue for the taxation of corporations at the same graduated rates as are applied to others? Such a tax would be at least a heavy penalty on mere size of an enterprise, for a large corporation on the average earns more absolute dollars than a small one.[8] Is it fair to tax corporate income to stockholders without likewise taxing corporate income to bondholders? Might not "interest expense" be an unfortunate hangover from the naïve idea that what must be legally paid out is expense?

Courts ignore the corporate fiction if in so doing they preserve the intent of the law.[9] However, in the most important Federal decision relating the individual to the corporation the separate entity view prevailed.[10] The court did not see that unless income earned by the corporation was earned simultaneously by the stockholder it cannot be said to be an interest of the stockholder before distribution. Elsewhere the Supreme Court has referred to such a stockholder's gain as "inchoate income." Is inchoate income which is measured and is available with only few restrictions income or is it not? A third category comprising something which is neither income nor contributed capital seems fairly general in current thought on the subject. This category might well be reviewed with the idea of its elimination. In deciding whether a stockholder realizes income when he re-

[7] The statement has sometimes been made that a corporation has no objective reality. There is no substance to such a contention. In some ways the corporation is more significant in modern economic life than the "economic man" and is less destructible than a stone wall or a cherry tree.

[8] It should be noticed in this connection that the tax statutes have not maintained as strict an analogy between the corporation and the natural person as might be supposed and the fact is suggestive.

[9] For discussion on ignoring corporate fiction see Wormser, I. M., *Disregard of the Corporate Fiction* (N. Y.: Baker, Voorhis, 1927).

[10] Eisner v. Macomber, 252 U. S. 189 (1920).

ceives a common stock dividend on common stock much was made of the point that in declaring a stock dividend the corporation gives up nothing. The court could hardly have meant that the stock received from the issuing company was not an asset in the hands of the recipient.

In determining realized income a distinction between the qualitative character of property rights in contrast to the quantitative cash equivalent should be made. The court held in the Macomber case that a common stock dividend in like kind is similar to making change. Two half dollars have a different composition than does a dollar bill, but one would not say that "changing" a dollar constituted the realization of anything. The decision had to rest on a distinction between the cash received and a share of stock which might have the same value as a cash dividend but the amount of which is not definitely proved or made liquid by conversion to cash.

If it can be argued that a stock dividend does not represent a gain to the stockholder, the same objection may be raised against calling a cash dividend income. The stockholders own the corporation, and a transfer of cash from the corporation depletes the stockholder's interest in the corporation by the same amount that the recept of cash would fill his purse. It has often been observed and it was emphasized in the dissenting opinion in Eisner v. Macomber that a corporate dividend paid in cash is devoid of gain.

To the stockholder who does not own the stock while the corporation realizes income, *realization* upon the mere receipt of a cash dividend cannot be denied, but if the notion of realization has substance, it must be distinguished from mere capital conversion. It is *gain* that must be realized. The accountant can have no purpose in setting up an item on the right side of an income account if by the necessary conditions of the case the item is equally matched on the left. Realization without gain would clearly be of this nature. This point seems to have been observed by the Supreme Court in the Stratton's Independence case.[11] The accountant's persistent adherence to the original cost basis of valuation rests on this issue. If original cost gives value, it is not in the absolute sense but as a basis for determining periodic gains and losses. Two valuations are necessary for the measurement of income and these are ordinarily made on two different dates. The question of realization is one of choosing the appropriate occasion for recognizing the right hand member of the income account. The entity view of the corporation is accordingly an obstacle to the satisfactory determination of personal income because of the lack of synchronization of realization of income by the corporate entity and of distribution in the form of cash equivalent to the stockholders. No ample provision is made at the time of distribution for maintaining the amount of the particular stockholder's capital. The transfer of surplus to the common stock account and an accompanying issue of new stock certificates does not come within the usual criteria of income; nor does any form of dividend.

The real error lies not in any legerdemain of the courts but it is inherent in the attempt to preserve a separate entity view of the corporation. Recently two writers have called attention to the general confusion of the entity and the association views of the corporation.[12] Corporate earned surplus is ordinarily considered an equity attaching to the common stock. It differs from common

---

[11] Stratton's Independence, Ltd. v. Hosbert, 231 U. S. 399 (1913).

[12] Husband, G. R., "The Corporate-Entity Fiction and *Accounting Practice*," 13 Accounting Review 241 (1938); and Kerrigan, Harry D., "Corporate Distributions as Income to the Stockholder," 13 Accounting Review 366 (1938).

stock in that it does not represent original capital contributed by any stockholder, but having been earned by the corporation, with generally accepted realization tests applied, its amount is supported by assets as valid as any assets which support the original book value of the common stock. After being earned and properly recorded on the corporation's books the surplus is as truly the stockholders' interest as is the original capital stock. The inconsistency is that of considering corporate earned surplus as the common stockholders' equity, yet denying that the process by which such surplus arises produces gain to the stockholder.

It is ordinarily easy to allocate the appropriate share of earnings to the individual stockholders before distribution. The surplus does represent different property rights of the stockholder than does the common stock, but unless when earned by the corporation it is also earned by the stockholder, when does the stockholder acquire the rights which he is presumed to have in the surplus from which a stock dividend (or any other) is declared? The answer of the entity view is that it represents a capital accretion to the owner while denying that it is at the same time income. Thus the stockholder may become richer while indefinitely postponing his income tax.

The rationale of the Macomber decision is that of looking passively at the accumulation of realized corporate earnings just as is done in the case of a supposed rise in the value of land. However, the two situations are not similar. In one case there is *measured* increment and in the other there is not.

Lack of availability for general use has been offered as a justification for distinguishing capital gains from income. It should not be supposed, however, that generally all increments of wealth are in cash or similar liquid form in order to be considered income. Especially for those whose income is subject to surtax rates, only a small fraction of the income need be in cash for purposes of consumption or payment of the tax. Those who are good subjects of surtaxes are investors interested in accumulating more wealth rather than consumers who accumulate little from year to year. The requirement of liquidity should be satisfied then if provision is made for their paying the tax in, let us say, obligations in the form of notes, redeemable under certain conditions.

Two Types of Accrual Distinguished. It is important to distinguish between the increase in book value of corporate equities and various types of appreciation in market value. The conversion test is applied in the former but not in the latter. With frequent transfer of equities between individual holders, the original cost to any individual frequently bears little resemblance to the value of the stock on the books of the corporation. Under ordinary accounting procedure the increase in book value of stock is made via sale at a profit of stock-in-trade or other articles or by similar criteria of realization. Under an association view the stockholder would accrue his share of such realized corporate profits. Many instances of mere market appreciation, on the other hand, are neither measurable nor susceptible to objective proof.

If an association view of the corporation were adopted for present purposes it would also be necessary to value stock at market when there is a market. A stockholder whose stock is "listed" is affected more by the changes in market price than by the books of the corporation. Moreover the market price is often more available to him in cash than are the corporate book assets. While it might be contended that the market at times becomes abnormally inflated or depressed,

nevertheless if cash is available by sale to another individual, the market price is backed by sufficient assets so far as the owner is concerned. Corporate book value is in such cases secondary in importance to the price available in the current market and may be treated accordingly in determining the measured change in the individual's economic circumstances.

Realization Criteria and the Stockholder. In a recent article Professor Kerrigan pointed out the confusion which results from trying to maintain an entity view of the corporation while rationalizing the stockholder's income status. His brief statement of the criteria of realization needs to be amplified. First, he says, one difficulty of imparting the character of income to corporate distributions is the allocation of income to a particular moment of time (moment of receipt) when in fact income is created over a period of time. Moreover,

> Adoption of the requisite of realization has introduced another difficulty; it raises the issue of what constitutes realization.[13]

Much has been written in favor of including all types of appreciation as income but little has been offered by way of a practical solution. It is unfortunate that income in the accounting sense should be spoken of so freely as a flow. The suggestion is that income may be measured in a manner comparable to reading a thermometer, meter, or calipers which readily measures a rise or decline. The word "flow" in this connection is misleading. Income is a value accretion which must be at least partially disposable at a market price in order that it be measured quantitatively or even that its existence be proved. It is a function of economic activity rather than a flow in time which can be measured at will.

Kerrigan's three conditions for realized income are worthy of further study.[14] The first—that the thing received must have a determinable fair market value—tells us nothing except that it have a determinable value. Any value the accountant could recognize would have to be a market value in some sense and the word "fair" is superfluous.[15] Only in an accompanying footnote is the real character of the problem shown. He rightly says that measurability of an item must not be confused with the nature of the thing itself. The nature of the thing is explained as consisting of two qualities (1) being subject to the recipient's use, benefit or disposal and (2) gain. Analysis of these two qualities shows that the first is open to more than one interpretation, and as for the second, the writer falls victim to the confusion against which he has cautioned his reader.

The second condition, gain, is by nature a quantitative and not a qualitative characteristic. The possibility of gain is the condition which justifies setting up the sum in question in the income account; gain is shown by reason of having done so. The quality of the asset received which justifies placing a sum in the income account cannot itself be *gain*. Gain, or loss is a conclusion to be reached only after the realization criterion is known and it is not itself any part of the realization criterion.

The second of Kerrigan's tests available to determine whether or not impairment of investment has occurred offers a plausible solution to the problem of conflict between the entity and association concepts of the corporation and the stockholder's income. However, the various ways in which impairment of capital may result as well as disposability to the recipient's separate benefit are not fully discussed.

The question of subjection to the

[13] Kerrigan, Harry D., "Accounting for Stock Dividends Received," 13 ACCOUNTING REVIEW 366 (1938).
[14] *Op. cit.*, p. 367.

[15] In the 1918 statute the expression "fair market value" was replaced by "readily realized market value," but was subsequently changed to the former.

recipient's separate use, benefit, or disposal raises the whole history of opinions expressed upon the merits of the stock dividend decision, and many influential writers have taken definite stands on one side or another of the controversy. One of the best-known writers to express an opinion is Professor Seligman.[16] His article is an early one written while the case was pending before the Supreme Court and it predicted the outcome of that decision with an almost mysterious accuracy.

Seligman's analysis of the realization criterion in the light of subsequent developments, however, leaves something to be desired. He says,

> Since the real wealth of an individual or a community consists of this inflow of satisfactions that we call income, it is clear that the satisfaction must be realized before we can predicate of it the quality of income. The satisfaction may come from the repair of a broken stove, from the occupation of a house, from a foal born to a broodmare.[17]

Thus Seligman apparently adopts Fisher's concept of income. But he continues that if the owner sells the services of the house, his "money income is correlative to the second party's pleasure income which, if not money, is money's worth." He fails to add that the measurable satisfaction or pleasure which the buyer of the service gets is reduced by the (dis-service) payment made to the seller. If the seller constructed the house without cost, the user's cost is net income to the builder, i.e., a measured value which he may consume after an exchange for the appropriate goods or he may otherwise dispose of it.

If the house is not rented or used, it is correct to say there is no income either to owner or tenant. If the house had a cost, the investment is an outright loss and should be so recognized in the accounts. It might be said of course that nothing could be lost, for the house being useless from the beginning, never had a value to be lost. Yet if economic resources which might have been devoted to other purposes were devoted to its construction, it must have had a capital value set in an actual even if a limited market (cost). Seligman offers no proof for the contention that the value upon construction was anything other than cost, and there is much to be said for such valuation. Valuation upon construction is based upon as much foresight as is then available. Subsequent events may justify taking a loss but in the actual course of affairs losses are taken when ascertainable and not by the attempt to retrace one's steps. This, however, need not preclude an amended income tax return under a reasonable if somewhat arbitrary statute of limitations. Market price, of course, may be *explained* at least in part by the discounting of expected future service as Seligman seems to say. The buyer exercises his individual judgment concerning expected future service when he decides to pay a price, as do others in a competitive market, and the expected service must at least equal the price paid. It is probably more.

Seligman's analysis of the dividend question ignores distribution and is apparently a confusion of a social with an individual concept of income. A community's income may consist of an inflow of satisfactions, but what of the distribution? The individual's income is determined by the distribution. To ignore the cost aspect in general is to ignore distribution. In a Society in which individuals make their way by specialization and exchange rather by by performing direct services for themselves this issue can scarcely be ignored.

Seligman insists that realization is a

[16] Seligman, E. R. A., "Are Stock Dividends Income?" 9 *Economic Review* 517 (1920).
[17] Seligman, *op. cit.*, p. 518.

necessary attribute of income, but does not satisfactorily define it. He insists, as does the Supreme Court, that a characteristic of income is separation. "The next characteristic of income is that it is something distinct and separate from the person or thing that affords the income. . . . The income of the house is really separate from the house itself." The latter statement is a mere assertion not explained or shown to be necessary to the concept of income. The reader is left to guess whether the separation is physical or whether it is separable for accounting purposes. If it is the former, the illustration picked is indeed unfortunate, for the physical service of the house cannot be separated from the house itself. If the use and the house must be separated only for accounting purposes, the point is meaningless.

When the attribute of separation is transplanted to the stock dividend situation, apparently it is physical separation that is meant. If "Separation is of the essence of enjoyment," then, it may be asked, how about a house, a painting, a diamond ring, or a magnate making a tour of his plant? How about a bank deposit on which $5 interest is accrued? As a matter of fact separation essentially has nothing to do with the problem except in the accounting sense; and to such a separation there is no objection, but this is not what either Seligman or the Supreme Court meant. This leaves no ground for a substantial distinction between a stock and a cash dividend.[18]

With Seligman the plumber's skill is,

> . . . indeed a part of him; but in order to secure the income that we call wages he must transmute his skill into something outside of, and separate from, himself. At a particular period he may render a service in repairing the stove; the service is then something separate from the man. If he disposes of the service, he enjoys an income. But he cannot secure the income without performing —that is, divesting himself of—this service. Separation, again, is of the nature of the transaction.[19]

Here cost is confused with income. What the plumber "separates" from himself is cost, not income. Separation anyway is the nature of only half the transaction. We must keep an individual concept of income in mind. Naturally in an exchange of goods or services when two parties are involved, and when the character of the exchange is such as to require physical delivery, there must be separation both physically and in the value or accounting sense. What the plumber receives is "gross income." He credits his income account for the receipts aspect of the transaction and debits it for the applicable costs which must independently have been determined in one or more other transactions. The net results is income or loss.

Seligman's analysis of the realization question is inadequate in part because of an unsatisfactory statement of the meaning of capital.

> At a given time the object or relation (human beings) which affords the utilities or the income is called capital.

Thus capital value might consist of physical things. This follows an explanation of capitalization, but if there is any doubt about Seligman's meaning, it is clarified when he says that "capital possesses a value which reflects our estimate of the

---

[18] The confusion of value with physical things is not uncommon in accounting, especially when durable equipment is concerned. The writing of such a well-known accountant as Castenholz will illustrate. He has said for instance that "By charging replacement against the reserve for depreciation, which must be done because it is impossible to separate a machine into its component parts for purposes of valuation, a hodgepodge of value has been produced even though each charge has been made at acquisition cost." (5 ACCOUNTING REVIEW 167) This involves the absurdity of saying that because paint sticks to a building it is not possible to carry the cost of paint in one account to be amortized over 5 years, and the rest of the building cost in another account to be amortized over 50 years. Anyone who believes the value of a piece of property and the physical property cannot be separated surely did not have money invested in real estate from, say, 1929 until 1932.

[19] *Op. cit.*, p. 520.

succession of anticipated utilities or income." If capital only possesses value and literally *is not* a fund of value, the economic problem is sidestepped, for the economic problem must be in value terms. It makes a difference which concept prevails, yet Seligman prefers a physical concept merely because "common usage" calls physical things capital. Common usage may be entirely wrong; also it may be susceptible to improvement. Capitalization *must* be in value terms and if capitalization is a process of valuation why is not capital a fund capitalized in any form and not just physical things? It is more to the point to say that capital is a fund and income is an increment of growth of the fund.

It should be emphasized also that neither income nor capital is secondary to the other. They are simultaneously determined so far as the accounting problem is concerned. The discounting of anticipated value in consumption in the market is not an accounting problem. Of course, for some purposes market prices must be explained, and in this respect capital value may be explained as discounted anticipated income. But so is cost. And the value of neither cost nor (gross) income is susceptible to a better method of measurement than to take the results of the market forces as alpha and omega of the accounting process. When the accountant measures income he rightly ignores the explanation of both costs and selling prices as discounting processes, when the discounting is based not on *actual* but only on *anticipated* income. Accounting income is a historical concept.

Seligman's statement of the comparison of income and capital is not especially objectionable, but in view of some of the conclusions he reaches one doubts whether he means what he says.

> Income as contrasted with capital denotes that amount of wealth which flows in during a definite period and which is at the disposal of the owner for purposes of consumption, so that in consuming it, his capital remains unimpaired.[20]

If by wealth is meant a value sum and by flow the accretions of value, there is no objection to the statement. Being disposable for consumption need mean only capable of being liquidated (even slowly) in the market, that is, directly or indirectly exchangeable for consumption or any other goods. A value sum in the abstract cannot be consumed. Neither can carrots if the possessor dislikes carrots and wants radishes. Seligman says that if:

> The stockholder receives some copper or wool, we should not say that it is unrealized gain, and that too, whether he keeps or sells the copper or wool.

But he insists that if a stock dividend is received, it must be sold in order to realize income. True, a man cannot consume a stock dividend. But neither can he consume cash. Suppose the stockholder has no use for copper or wool but wants a house to live in. Would it not be just as well to have some marketable stock received as a dividend as it would copper or wool? It is probably not correct to interpret Seligman as meaning that "wealth" at the disposal of the owner "for purposes of consumption" has to be embodied in the physical form of just that consumer's good which the owner at the time happens to want to consume; it would seem sufficient that it be in the form of any readily marketable good or claim. He tells us that "the income may not be consumed, but saved and added to capital." And he adds that "accretion to capital is clearly nothing but accumulated or converted income."

Let us consider his example which implies a bank deposit of $100 on which there is accrued $5 interest. If "The income has been realized and separated

[20] Seligman, *op. cit.*, p. 523; also *The Income Tax*, p. 19.

from the principal," as Seligman says, is the separation physical separation or is it available value to be accounted for? An acceptable conclusion concerning the nature of a stock dividend seems to require an answer to this question, but Seligman obscures the point by his choice of an example. He merely finds it "easy to keep the two sums separate and distinct. No one can question the fact that the gain, even though added to the capital, is pure income.[21] The question he says becomes complex when we deal not with money but with money's worth. Continuing, he says, in a growing forest if the annual cutting is replaced by the growth of the remaining trees, the cutting is income, but if the equivalent of a year's growth is allowed to stand as an increment it is said not to be income. Mere cutting, i.e. separation, transforms the capital increment into income. Should it be said that the cut timber is suitable for consumption and the timber on the stump not? It is one stage nearer the completed house but what is the magic of cutting down trees and sawing lumber that transfers capital increment into income? Here again there seems to be a confusion of individual and social income. Is it not the condition or relationship of the market which is the controlling factor?

Consistency would require either delay of recognizing any income until the house is lived in or else calling the new growth of a valuable forest income. Why is a few more board feet on a tree not income if a definite price can be assigned to it? To say because it is not separated is to assert and not to offer a plausible explanation. Again Seligman asserts that "from the economic point of view" there is a distinction between increase in the form of income and increase in the form of capital, but he does not show a rational basis for the distinction. We are left to guess that it is consumption, but we also find that,

> If the income is immediately enjoyed or dissipated, the increase of wealth disappears with the enjoyment; if the enjoyment of the income is postponed or deferred, the increase of wealth is not dissipated. In the one case we have spending, in the other saving. Capital can be increased only by postponement of enjoyment.[22]

Obviously income does not refer to consumption in Fisher's sense if it may be *postponed* or *deferred*. The only answer seems to be that it too is an increment of capital if saved. What can be the distinction between income and increase in the form of capital? To say that capital can be increased *only* by the postponement of enjoyment comes near to denying the productivity of capital.

It might be admitted that realizability is not realization and separability is not separation, but in the case of goods readily marketable at will are these not equivalents after allowing for the almost insignificant selling costs? The Treasury Department has on numerous occasions held the receipt of valuable property to be the equivalent of cash and not had its rulings overthrown by the courts. It seems strained to say that gains from appreciation of property saleable at known prices are to be denied the status of income on account of being measured directly by cash rather than existing in actual cash form. The crucial tests seem to be measureability and disposability of the increment to the owner.

Again, there is a distinction to be made between income as determined by the accountant under the least questionable tests of realization and enhancement in value of resources because of greater expectancy of future income, caused, let us say, by an increase in the demand for

[21] Seligman, *op. cit.*, p. 523.

[22] Seligman, *op. cit.*, pp. 524–5.

the product of capitalized resources. But the accountant should be reluctant to recognize such an increase in capital value for want of adequate valuation figures. Given reliable valuation figures, there can be found no fundamental distinction save a legal one between "revaluation surplus" and "earned surplus," for example. For the achievement of the ultimate economic goal of the owner of the enterprise (his own consumption or additional investment) there is no difference between these two surpluses. Each may be equally available for separate disposal depending on circumstances other than the source from which the gain arises.

If an acre of land, for illustration, which cannot be "split" appreciates from $1,000 to $1,200 in value, what is there in the nature of separability that denies recognition of $200 income for the period of such a rise? The hypothetical character of the valuation must be eliminated by assumption. If the owner sells, the $200 is separable if not separated; if he does not sell, it is because he himself values the land at or greater than $1,200 and *prefers* to have the $1,200, which is available in the market, invested in the form of land. If he has bought the land for $1,000 and stubbornly continues to value it at cost, either there is no actual market at $1,200 and hence he is rationally conservative, or there is an inconsistency between his economic conduct and his set of books. If there is a market at $1,200 and valuation for his own use is less, he should sell. If he does not sell, he values the land at $1,200 as a bit of mental memorandum which is out of harmony with his bookkeeping. If the land is such an integral part of the owner's productive plant that it is inseparable from buildings or other construction, there is little use of talking about the market for the land. The acre is physically not available. Great care must be taken to be assured of the existence of an actual instead of an assumed or an imputed market. Since such an item as land seldom enjoys an actual organized market for identical units, some sold and some not, such as shares of stock in the New York Stock Exchange, the landowner is right in valuing his land for an indefinite time at original cost, which represents his investment in the land. There may be nevertheless occasional exceptions to this rule. These exceptions are usually associated with business reorganization or securing loans.

Seligman would, as did the Supreme Court, consider a dividend paid in the stock of another corporation income because he found in this situation "both separation and realization." He does not show why from the standpoint of the recipient the stock of both the issuing corporation and that of another corporation are not equally disposable by the recipient for his separate use. True, in the one case the corporation does not surrender any assets, but this fact does no alter the quantity of value which the recipient gets as property rights. A stockholder may gain title to legal property by receiving either assets which the corporation surrenders or an equitable interest in other assets. Why is there "separation" in one case and not in the other? Moreover, why need there be? If the recipient's dividend is in stock of the same corporation, his interest in the company is no less real or direct than is his interest in the second corporation whose stock he receives. Yet both Seligman and the Supreme Court have called the latter income and have denied this status to stock received from the issuing company. Seligman admits that,

> Whether the stockholder gets cash, or commodities in the shape of copper or wool, or the securities of the other corporation is immaterial to him.[23]

Why *is* it material to him if he receives

[23] Seligman, *op. cit.*, p. 535.

stock in the same corporation? This is answered only by an assertion that there must be separation, and that this does not constitute separation. Yet stock of a second corporation received is *realized* gain. In fact, "it is realized in the true economic sense of the term," just as would be the case if he received wool or copper. Why should it matter in general to the stockholder in which corporation his interest may be invested?

Seligman concludes the argument that a stock dividend is not income by saying that the stockholder "is no richer than he would have been if there had been no stock dividend at all but a simple distribution to surplus." While this can readily be admitted, it is not consistent with his contentions that a similar sum on the corporation's books *is* income to the stockholder when paid in cash. It is true the recipient has realized cash in the latter case and this is ordinarily a more liquid form of asset; it is more readily converted to other goods. But to call a cash dividend income and to deny the same status to a stock dividend is to ignore the requirement of preserving the original investment before recognizing income in the case of cash and to ignore income while growing richer in the case of stock. If the preservation of the stockholder's investment is essential before recognizing income there is nothing inherent in the receipt of any dividend that requires recognition of income. The association view recognizes this fact.

Realization, a feature of income which Seligman does not adequately relate to the idea of separation, perhaps means no more than the appropriate occasion of an accounting for income. If a cash dividend is realized income, it is because the receipt of a cash dividend is the most opportune occasion for an accounting, while it is not practically feasible to account for capital depletion. The income account is simply credited with the amount of the dividend received. But the same accounting principles which are insisted upon so ardently in general require that there be maintenance of the value of the source from which the income is derived before there is any (net) income. Why so naively ignore this requirement when a corporate dividend is received? If the fiscal period of the corporation and corporate distributions coincide perfectly, then cash dividends could be income. Would the same not be the case if the corporate income were capitalized as a stock dividend? The only difference is in the *quality*, not the *quantity*, of the asset which the stockholder receives.

Professor Simons, who criticizes Professor Seligman's realization criterion (and the Supreme Court's), is perhaps not in favor of abondoning realization but of adopting more plausible criteria.[24] He sees that realization is a characteristic apart from gain. Gain is the result of comparing realized conversions (sales) and realized applicable costs. Immediately, however, he foregoes such an acceptable interpretation and, apparently forgetting what he previously stated, accepts Fisher's concept which he elsewhere denies by adding that,

> Realization, broadly conceived, is something achieved only in consumption, for only there does one find a stopping place among the sequence of economic relations. Consumption is essentially a destruction, a using-up, an end. Such a solution of the dilemma, however, is not one that will commend itself to most advocates of the realization criterion.[25]

Just how broadly does realization have to be conceived before it becomes consumption? Whatever may be the broadest conception of realization, it is not achieved only in consumption if it has any application in accounting. What is realization

[24] Simons, Henry C., *Personal Income Taxation.* (University of Chicago Press, 1938) pp. 88–89.
[25] *Ibid.*, p. 89.

functionally conceived? It at least serves as a necessary means of measurement by insisting that income be in a form disposable at least in part to the owner in a form which can be directly compared with cash. It should be pointed out in this connection that creation of a "social product" for consumption is not essential to the fact of measured individual income.

Accounting for Income Under the Association View: The difficulty of synchronizing realization and gain, inherent in the entity view of the corporation, can be avoided by accepting an association view. This should, however, not be confused with an association as a group of partners. It does mean however that all investors, stockholders and bondholders alike "take up" their appropriate share of earnings as reported by the corporation. The technique of applying such accounting is relatively simple and convenient. The substance of the procedure may be stated briefly as follows:

The cost of stocks bought is recorded in three accounts. The buyer consults the most recent corporate statement and ascertains three valuation figures: (No. 1) the par (or similar) value of the stock; (No. 2) the book equity (surplus or deficit) over par value which is assignable to the stock in question; (No. 3) the difference between total (or net) book equity and the price paid for the stock, that is, the market premium (or discount). Thus stock acquired is valued initially at cost just as at present. The stockholder's proportionate share of the corporate surplus (or deficit) is carried as an adjunct (or contra) to the asset account representing par. The third account shows the difference between the algebraic sum of the other two and is carried as an adjunct or contra to the sum of the other two. At the end of each fiscal period the corporate earnings are added to the asset surplus (or deducted from a deficit, etc.)

Ordinarily the capital stock account will require no adjustment, but when there is a capitalization of surplus, for instance, there will be a decrease in surplus and an increase in the capital stock account. There will be no income. The adjunct account, (No. 2) above, which shows the stockholder's equity in the corporate surplus, will be adjusted annually on the basis of the published corporate income report, and corporate income is accordingly income to the stockholder. A cash dividend will be handled similarly.

It is a common criticism that the investor often finds it difficult to interpret a corporate report. Accordingly it must be remembered that the report should not be made unnecessarily complicated. On the other hand there can be no justification for failure to develop more logically constructed accounting reports because of ignorance or indolence of the investor. It is as legitimate to require the investor to learn some accounting as it is to ask the accountant to prepare a more intelligible report. There is nothing in the nature of the simple method suggested here that requires a compromise with the investor who will not or cannot read and understand his annual corporate report.

The procedure which assumes identity of interests of stockholder and of corporation is realistic from the economic point of view even if it diverges from legal tradition. There is no logical reason for not taking the association view as the one most realistic, and positively there is much to be said in favor of the view. If the objection lies in "human nature" or custom instead of in logic, it may be rather the stubbornness of human nature that is the cause of the absurdities. In a scholarly work by a committee of tax specialists working under the editorship of Carl Shoup the association concept of corporate income has been strongly recommended.[26] The legal adop-

[26] Shoup, Carl, ed., *Facing the Tax Problem* (Twentieth Century Fund, 1937).

tion of an association view of corporations for income tax purposes might not be as far distant as might be supposed. A limited use in the case of closely held stock is made now. In the Revenue Acts of 1937 and 1938 a limited use of this view was provided. Section 24-b-2A of these Acts reads as follows:

Stock owned, directly or indirectly, by or for a corporation, partnership, state, or trust, shall be considered as being owned proportionately by or for its stockholders, partners, or beneficiaries.

Constitutionality of the Association View of the Corporation. There has been no general attempt to tax the stockholder on his distributive share regardless of actual distributions since the 16th Amendment. The view, however, might be legal if Congress chose to act. The civil war acts establish a precedent which has received sanction in the Supreme Court. The decision in Brainard b. Hubbard,[27] important in this connection, seemed to have been forgotten when the entity view was adopted by the majority opinion in Eisner v. Macomber, but the language giving judicial support to the association view is clear and merits presentation here at length.

By the finding, it appears that at the time of the assessment the plaintiff owned a majority of the stock in two certain manufacturing corporations, whose affairs respectively were managed by three or more directors, of which the plaintiff was one; that the profits realized by the respective companies the year preceding the assessment were greater than the dividends which they made within the same period; that the profits at the time of the assessment had not been divided nor had they been in any way set apart from the general assets of the respective corporations, nor had they been appropriated for the use of the stockholders, otherwise than the law will imply from the fact of the existence of such profits; . . . the assessment was legally made, if such profits were in law liable to such an assessment.[28]

Congress evidently intended by that act, (of 1864) . . . to tax all the annual gains, profits, and income of every person . . . whether derived from any kind of property, rents, interests, dividends, salaries, or from any profession, trade, employment, or vocation, or from any source whatever, except as therein mentioned. . . . Section 117 declares what shall be included in estimating the annual gains, profits, or income of any person and, among other things, expressly provides that the gains and profits of all companies, whether incorporate or partnership, other than the companies specified in that section, shall be included in estimating the annual gains, profits or income of any person entitled to the same, whether divided or otherwise.[29]

Decided cases are referred to in which it is held that a stockholder has no title for certain purposes to the earnings, net or otherwise, of a railroad prior to the dividend being declared, and it cannot be doubted that those decisions are correct as applied to the respective subject-matters involved in the controversies. . . . Grant all that; still it is true that the owner of a share of stock in a corporation holds the share with all its incidents, and that among those incidents is the right to receive all future dividends, that is, his proportional share of all profits not then divided. Profits are incident to the share to which the owner at once becomes entitled provided he remains a member of the corporation until a dividend is made. . . . Regarded as an incident to the shares, undivided profits are property of the shareholder, and as such are the proper subject of sale, gift, or devise. Undivided profits invested in real estate, machinery, or raw materials, for the purpose of being manufactured, are investments in which the stockholders are interested, and when such profits are actually appropriated to the payment of the debts of the corporation, they serve to increase the market value of the shares, whether held by the original subscribers or by assignees. But the decisive answer to the proposition is that Congress possesses the power to lay and collect taxes, duties, imposts, and excises, and it is as competent for Congress to tax annual gains and profits before they are divided among the holders of stock as afterwards; and it is clear that Congress did direct that all such gains and profits, whether divided or otherwise, should be included in estimating the annual gains, profits or income liable to taxation under the provision of that act.[30]

It should first be observed that the case involved a stockholder who owned a con-

[27] 12 Wallace 1 (1870).
[28] 12 Wallace 1 at 10.
[29] 12 Wallace 16 (1870).
[30] 12 Wallace 17–18.

trolling interest in the corporation. It might be contended that there is no objection to requiring a stockholder with a majority interest to report his share of corporate income as earned by the corporation, whereas it may not be fair to impose a similar tax on a minority stockholder. This question is in any case one of wisdom and not of a limitation on the constitutional power of Congress. The court upheld the statute on the power of the Commissioner of Internal Revenue to enforce an act of Congress which generally applied the association view. Brainard v. Hubbard seems to be a clear precedent in support of the association view so far as the constitutional aspect is concerned. Thus the association view would require only an act of Congress in order to be legal.

The question of an association view was not raised in the majority opinion of Eisner v. Macomber. However, Mr. Justice Brandeis in a dissenting opinion expressed the possibilities of such a view in support of the contention that stock dividends received are income. While the Brainard v. Hubbard decision interpreted an act of 1864 before the 16th Amendment, this amendment in no way attempted to define income. It placed no limitation on the power of Congress to tax; it has often been pointed out that it did no more than remove the limitation already imposed by the Constitution that Congress may not impose a direct tax upon individuals without apportionment among the states according to population.

Personal-Service Corporations. The statute of 1918 taxed stockholders in personal-service corporations as members of a partnership.[31] The corporation itself was not subject to an income tax, but any portion of the net income not distributed at the close of the taxable year was to be accounted for by the stockholders in proportion to their respective shares. The personal-service corporation defined as one "whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor; . . . "

The similarity of this type of situation and the taxation of corporations in general, however, should not receive too much emphasis. The difference between the personal-service corporation and the partnership is relatively more of a legal formality than is the difference between the partnership and the corporation in general. In the personal-service corporation each stockholder is usually directly active in the management and may even participate in the production of service. Usually the capital investment is small. From all standpoints except the privilege of incorporation for such purposes as lend themselves to abuses, the organization is managed like a partnership. In some large industrial corporations production and management are functions widely separated from the function of investment and are carried out by different individuals. This separation itself may be a strong argument against an association view for all corporations, large and small, but for numerous small corporations there may be a stronger case.

The case for the association view in general must be justified on the grounds of the taxation of net equitable gain of the individual stockholder rather than on the grounds of tax evasion or the possibility of the improper accumulation of a corporate surplus. But since the greatest obstacle to the adoption of the association view seems to be legal, Brainard v. Hubbard and the statute of 1918 are significant as precedents. The provisions of the act of 1918 were not tested in the courts; but if they

[31] Section 218(e) of the Revenue Act of 1918. The provision was repealed as of December 31, 1921. See Section 218(d) of the Revenue Act of 1921.

were, there is some possibility that the court might profess to look to the substance rather than the form of the business entity and find reason for ruling that the personal-service corporation is essentially a partnership for income tax purposes without taking such a position generally. A more substantial precedent, however, seems to exist in the case of Brainard v. Hubbard.[32]

Conclusions. The corporation is not a natural person and should not be taxed as such. A corporation is owned in its entirety by various investors. It is a vehicle for the receipt of funds, the acquisition of economic factors of production, and physical production. On the one hand it distributes its product by sale to customers while on the other it distributes the net corporate gain in the form of cash or the equivalent to those who hold an equitable interest in the enterprise. The stockholder's investment also may increase by failure to distribute earnings.

For purpose of an equitable personal income tax the stockholders might be required to accrue their equitable interest in realized corporate income as soon after it is acquired by the corporation as is administratively feasible. Such an accrual will permit the preservation of the investor's individual capital before itemizing dividends as income. This will assist in the elimination of a tax-evasion loophole. It will permit the taxation of individuals more nearly in conformity with their respective improvement in economic circumstances. It will remove an unintended tax penalty upon the corporate form of business organization and at the same time tend to remove the existing discrimination between bondholder and stockholder.

Corporate surplus is a measured gain to the stockholders and may be fairly apportioned before distribution. It is available in at least a limited sense either in a regular stock market or at the discretion of the corporate directors.

[32] Brainard v. Hubbard, 12 Wallace 1 (1870).

REALIZABLE VALUE AS A MEASUREMENT OF GROSS INCOME

Reuel I. Lund

The point at which the income stream is most properly and conveniently measured is a question which has received considerable attention from economic, legal and accounting writers. The economic definition of income is usually in terms of consumers' goods; it may be defined as their output, or the purchase of them, or the amount consumed, or the reaction of the consumer to the utilization of such goods. Probably most economists regard the latter as the proper concept of income but discard it as a workable concept because of the impossibility of its satisfactory measurement. They, therefore, find it necessary to fall back on a definition in terms of the value of the services rendered to individuals and of the value of the goods consumed by them. The measurement of the income stream at this point is then assumed to be somewhat representative of the human reaction or satisfaction that results from consumption.

In both the economic and the accounting concept of income there is the notion of service rendered to someone. The accountant, in a sense, measures the service rendered to the owner or owners by the

business unit. Only insofar as there is a satisfactory return to the owner of a business, after full provision is made for the upkeep of the business unit, is the owner interested in its continuance on a permanent basis.

The desirable qualities to be attained by business income prior to its recognition on the books of a firm can only be briefly outlined in this paper. The following criteria have been laid down by accounting writers, although it must be admitted that there is a considerable difference of opinion on the subject:

1. The earning process should be substantially complete, at least to the extent to which the income is recognized.
2. The income should preferably be evidenced by an increase in working capital (realization).
3. It must be subject to dependable measurement so that the amount may be reliably determined.
4. It is desirable to have the recognition of income follow from some regular business transaction.
5. Such a transaction, which establishes income, should preferably be with outsiders, in order to remove the possibility of the creation of a fictitious income by estimates or subjective valuations.
6. Income should not be legally subject to revocation in a subsequent period.

There are several tests of income which meet these standards more or less adequately:

1. The sale is the test which, in most cases, meets all of the standards satisfactorily.
2. The market quotation of the merchandise produced, finds proper application as the test of income in a number of cases in the agricultural and extractive industries. In these industries there is commonly a ready market for the product. No effort or important expense is necessary to accomplish the sale. Income may then be measured at the completion of production. Income-tax regulations permit this method of measuring income, for income-tax purposes in the case of farm products and in that of securities held by a dealer. Accountants, in general, recognize the propriety of taking inventory at realizable value in the case of by-products, since separable costs are lacking.
3. Recognition of profit as production proceeds. In the case of long-term contracts, if the profit or loss were all taken in the period in which the contract were completed, the report would probably be so tardy as to lose much of its usefulness for managerial purposes. Investors and creditors (prospective as well as actual) would then lack an important guide in their decisions. Furthermore, income taxes may be unfairly determined under a procedure of reporting several years' earnings in one. It is, therefore, generally considered permissible to allocate profits on long-term contracts to interim periods. Income-tax regulations also recognize this method of reporting.
4. Deferment of income until cash is received, has been applied principally to the cases of professional income and of installment selling. The Federal income-tax law has recognized such special application to installment selling of both personal and real property, beginning with the 1926 Act.
5. Considerable has been written on the desirability and nondesirability of recognizing appreciation as income. It should be obvious that the appreciation of fixed assets does not measure up to most of the six standards that were proposed as desirable for the recognition of income. A consideration of this type of income is, however, beyond the scope of this paper.

Attention will now be given to the second of these five tests of income. It is maintained by the writer that the utilization of realizable value of product as a measurement of gross income has sufficient advantages under the circumstances found in some industries to justify careful consideration; also, this test of income meets adequately the six requirements which were laid down earlier for the recognition of income.

THE CASE FOR REALIZABLE VALUE

The recognition of business income is commonly deferred until the product is sold. Several circumstances connected with the disposal of the merchandise of most businesses makes advisable such de-

ferment. The possibility of sale is usually more or less uncertain until brought about. Also, considerable selling expense must usually be incurred. Advertising, display of merchandise, sales effort are examples. Another common characteristic of the disposal of such merchandise is the need at all times for a stock, so that there may be goods available from which the customer may make a selection and from which he may receive immediate delivery. This need for a minimum inventory is characteristic of practically all retail, wholesale, and many manufacturing establishments. In part, the above activities and costs are for the purpose of attracting customers, but they also represent services which are offered with the product. A considerable time, in general, elapses between the time when the merchandise is ready for sale and the actual sale, provided the company is successful in its sales effort. In the case of firms for which the market must thus be sought, created or anticipated, the merchandise on hand cannot well be considered a "near-cash" item. To a large extent, before it can be sold, it must be replaced by other merchandise to maintain a minimum stock. Then, too, the amount that can be sold at the fixed price or at any price is not certain. The length of time that will elapse before an effective demand for the merchandise can be awakened or created is another unknown factor. Also, the amount of the negative income (selling expenses) that will be involved in such ultimate realization is uncertain. The booking of income earned by the business process must, therefore, await the sale, where the above circumstances are present.

There are, however, a considerable number of commodities, which may be marketed without such delay, cost and uncertainty. As soon as the commodities are ready for market they may be disposed of almost immediately on a market which is not noticeably affected by such disposal by the individual producer. It is contended that under these circumstances the income should be recognized on the product immediately on completion. The advantages of such immediate recognition of income as opposed to a postponement, until the sale takes place, many be enumerated.

1. The period during which the income is earned and the time at which such income is recognized in the statements are brought closer together. In fact, the income is, thereby, recognized immediately on the completion of the earnings process. The profit-and-loss statement, therefore, becomes more representative of income earned from operations. From the standpoint of business management, a disclosure of the income earned during a fiscal period, whether such income has been realized or not, is probably of more importance than a calculation of the amount realized. It is, it would seem, more indicative of the efficacy of the business unit during that period. Therefore, if a recognition of income realized is widely divergent from the amount which may be reasonably allocable to that period as having been earned, it may even be advisable to use an estimated-earnings figure rather than delay recognition until realization is attained. Such has been the conclusion of many accounting writers and practitioners in the case of long-term contracts, as has already been indicated; also, in the case of aging or curing, the earning process may precede realization of income by a considerable period, and it seems that serious consideration should, then, be given to the advisability of recognizing income as the earning process progresses rather than deferring such recognition until the accumulation of five or ten years' earnings has reached the realization stage. An examination was made of the statements for all of the companies that were engaged in the distilling of liquors as presented in Moody's Manual, and in only one case was there any indication that some recognition had been given to such unrealized earnings.
2. A separation becomes possible, although not necessary, between the income on production and the income on speculation, from holding the company's own product. In such a case there should be indications on the profit-and-loss statement whether such holding policy has been profitable and, con-

versely, to what extent the main operations have been successful.

3. Any such marketable goods on hand would be more truly "near—cash" than receivables. Therefore, income may, in such a case, be regarded as realized as soon as production has reached the marketing stage. The receivables have to remain dormant during at least the credit period; not until 30, 60 or 90 days have elapsed, is there any possibility of turning receivables into cash. The inventory, on the other hand, can be sold at any time—the only delay, in most cases, being the time necessary for the transportation to a market; and, when the sale takes place, the proceeds are, characteristically, cash—not receivables.

There is one offsetting disadvantage to the recognition of income when it is in the form of such marketable merchandise rather than in cash or receivables. This disadvantage may seem serious at first glance but the writer believes that it loses much of its importance on further examination. The amount that will be received eventually in cash when the stock is sold is, obviously, not known in most cases. It may change considerably from that indicated by the present market quotation. In other words, the profit that is ultimately made on the sale is not known prior to such sale.

In answer, the writer needs only to point out that the profit that is taken up at the end of the production period does correctly represent an amount available in cash on the closing date. That the amount may change is due entirely to the wish of the management to hold the merchandise for a better price. The speculative profit or loss would necessarily be included in a following period, but the profit from production is earned in the first period, and is "near-cash" at the completion of that period.

Conceivably, too, a profit in the form of merchandise stock which is readily realizable might, at times, be better protected than one in the form of cash. A general change in the price level, to which the merchandise has conformed, would, obviously, leave the profit in the form of such merchandise, intact, but would change the amount of the real profit if it were in the form of cash.

In this paper will be considered mainly the industries in which it is customary to measure income at the completion of production rather than at the completion of sales. To a large extent such industries may accomplish that result by valuing inventories at market quotations rather than at cost. By market quotation is meant the estimated realizable price as of the date of the balance sheet, with a deduction for any necessary costs of transportation and marketing. As previously noted, in order to measure income in this way there must be available a market in which the merchandise may be readily absorbed. Also, the merchandise must be available for sale in entirety. If part of the merchandise is, in any case, to be retained, in order, for example, to take care of a preferred demand outside the market, or the demand of subsidiaries, or a demand in the company's own manufacturing process, such minimum stock is not separable from the business whole as a valuation problem.

Some of the larger ready markets in America and the commodities traded on them are noted in the following list:

Name of Exchange	*Commodity*
New York Cotton Exchange	Cotton (100 bales) Wool Tops
New Orleans Cotton Exchange	Cotton (100 bales) Cotton (50 bales) Cottonseed Oil (in bulk)
Chicago Board of Trade	Cotton (50 bales) Wheat, Corn, Oats, Rye, Soy Beans, and Barley Lard Ribs and Bellies
Chamber of Commerce Minneapolis	Wheat, Corn, Rye and Barley Oats Flaxseed
Winnipeg Grain Exchange	Wheat, Oats, Rye, Barley, Flaxseed
New York Coffee & Sugar Exchange	Raw Sugar #3 (50 tons) Raw Sugar #4 (50 tons) Coffee A (250 bags) Coffee D (250 bags)
New York Cocoa Exchange	Cocoa Beans

Name of Exchange	*Commodity*
Commodity Exchange Inc., New York	Tin (5 tons)
	Copper (25 tons)
	Lead
	Zinc
	Crude rubber (10 tons)
	Hides (wet salted)
	Raw Silk (10 bales)
New York Produce Exchange	Cottonseed Oil (in bulk)
	Black Pepper (15 tons)
	Tallow (in bulk)
	Peanuts (shelled)
Chicago Mercantile Exchange	Butter (300 tubs)
	Eggs (400 cases)
	Potatoes (360 bags)
	Hides (wet salted)
Memphis Merchants Exchange	Cottonseed Meal (100 short tons)[1]

At least two commodities, for which there are large ready markets, are not included in the above list. Gold and silver, although not included, have, of course, not only ready but also stable markets—stable in monetary terms; necessarily stable for gold, if gold is the ultimate monetary standard; but, also, in the recent past, stable for silver due to government sponsorship.

Other commodities suggest themselves, which have, it is believed, a ready market, as far as most of the producers are concerned. In the case of some producers, their particular product may be of a superior quality and, as such, have a separate noncompetitive market, even though a competitive market exists for the main supply of that commodity. The superiority may be a real one, or a more or less imaginary one, created by advertising or sales effort. In either case, the amount marketed will probably be controlled to such an extent as will supposedly yield the maximum net. Thus, it may be stated, in summary, that not necessarily all of a supply of a commodity for which there is a ready mar-should be valued at the realizable price.

Other examples of commodities for which there exist more or less ready markets, are: tobacco; hogs, cattle, calves, sheep, poultry; fruits; vegetables; rice; nuts; coal; wood; lumber; petroleum.

[1] From a circular issued by E. A. Pierce & Co.

For some of these products associations are set up to handle the supply of members. The association may then take the entire output of the members and market such part as they decide to be advantageous, pooling the returns; they may market what they can for members at a predetermined price; or they may decide for each member the quota which he may market, which is then marketed through the association. Under none of these arrangements is marketing or selling effort necessary on the part of the individual producer. If, therefore, the approximate realizable price for such producer is known with a fair degree of certainty, it would seem that the valuation of the produce might reasonably be made for the grower on that basis and profit taken accordingly as soon as production is complete—that is, as soon as the product is ready for delivery to the association, even though delivery has not been made, and sale by the association is even more remote. An amount so determined is what the crop is worth to the grower; that is what he can look forward to, as the proceeds, with which to carry on. If his produce should be destroyed, that value would be the amount of his loss.

The type of product for which ready markets are available and utilized should be noted. They are: agricultural products; products of the extractive industries. These products have the characteristic in common that they have been taken from the soil, directly or indirectly. The most indirect would probably be dairy products, eggs or wool. Not quite so far removed would be livestock and poultry available for marketing. A step nearer again would be grain, cotton, potatoes, tobacco, etc. The products which have their origin most obviously and directly in the soil would, of course, be those of the extractive industries. Thus several degrees of remoteness from the soil might be set up for such products. In general, it may possibly be said

that all products which have such close proximity to the soil have characteristically a ready market; and, therefore, come in this group for which profit should be taken as soon as production is complete. The group includes very nearly all the raw materials, and includes a number of consumers good. Milk, butter, rice, fruits, vegetables, nuts, poultry, wood, coal and many others of such commodities are purchased by the ultimate consumer. It follows that the commodities which do not fall in this group, i.e., the commodities for which there is no ready market but for which sales must be accomplished by influencing the individual customer through advertising, display, salesmanship, or otherwise, are characteristically manufactured goods. Their raw materials, however, are, at least originally, of the former type and were obtained, before the manufacturing process commenced, through a ready market.

In the extractive and agricultural industries, the sale activity plays usually a minor role in the earning process. For a considerable number of the products of these industries, a ready market is available to absorb the product of any one company, whenever it wishes to sell. No sales effort is necessary. Here a dependable measuring stick of the value of the product and consequently the income from production is at hand in the form of market quotations whenever the product is marketable. Realization also is present, since the acquisition of the product increases the current assets and the working capital. The product in this case is "near-cash." Note that the products of these industries are raw materials, while those of the merchandising, manufacturing and construction industries are almost entirely finished goods. The possibility of standardization is, of course, more likely for raw materials.

Some of the products of both mining and agriculture, however, do not have ready markets available, in which case the sale must be consummated before a measurement of income is possible. In a few cases, also, a producer may be so large that the market cannot readily absorb his product. Since marketability of all his product at will is not possible at the market quotation, it cannot all be valued accordingly. If, say, a fourth of the total product might conceivably be marketed within a short period, without a serious effect on prices, that much might, it would seem, be considered immediate gross income; the income on the remaining stock should, however, not receive recognition until the stock is sold.

TEMPORARY INVESTMENTS

The profit or loss on temporary investments is usually measurable and realizable without disturbing the functional efficiency of the business unit. Any increase in their value meets the requirement of realization; usually temporary investments are more truly "near-cash" than any other current asset, except cash.

Whether the investment be in stock, or bonds would seem to make little difference, if there is a ready market from which quotations may be taken for measurement of value and if the securities may be sold without affecting the earning capacity of the remaining assets. X buys 100 shares of U. S. Steel at 50. He expects a considerable appreciation over the next five years and plans to hold the investment for that duration. At the end of the calendar year the stock is selling at 53. Since there is an increase in the value of his holdings of $300, less commission, he has a gain of that much, regardless of whether he sells them or not. A sale is not necessary for the determination of his profit; if he sells, the sale gives him cash instead of 100 shares of stock; the sale represents only a conversion of assets, not the earning of a profit. The profit came about through the enhancement in the market value of the stock. To

proceed with this case: the end of the year U. S. Steel selling at 52; if he still holds the stock, he has a loss for the year on his investment of $100. The third, fourth and fifth years give the following quotations on December 31:

3rd	57
4th	70
5th	62

X sells the stock during the sixth year for $6,800. The commission is $15 each for the buying and selling operations. The following is an allocation of profits and losses on this investment to accounting periods:

1st year	profit (300–30)	270
2nd year	loss	−100
3rd year	profit	500
4th year	profit	1300
5th year	loss	−800
6th year	profit	600
Total profit for the 6 years		1770

According to the usual accounting procedure, all of this profit of $1,770 would have been allocated to the year in which the sale was made, instead of an allocation of $600, the actual enhancement in value which took place during that period.

GOLD AND SILVER MINING

There are a number of accounting writers who have recognized the reasonableness of taking a profit in the gold-mining industry as soon as the gold is recovered.

It may be well to note three characteristics of the marketability of gold which make that commodity so generally recognizable by accountants as income as soon as recovered rather than at the time of sale:

1. It has a ready market. No sales effort is necessary. This is, of course, as we have noted, a characteristic of many products, especially products of the soil, by either extraction or production, and dairy and poultry products, and livestock. This characteristic, a ready market, is, to the writer, the only necessary circumstance which makes it desirable to measure value, and consequently income, as soon as the product is marketable. If the product is held by the producer beyond this stage, he is engaged in the operation of speculation, which should receive its separate allocation of profit or loss.
2. In the case of gold, the possibility of fluctuation in monetary terms is remote, since monetary units are quite commonly valued in terms of a definite quantity of gold. Thus, since gold is valued in terms of itself, the possibility of speculation for a rise in price is absent. The final monetary income from gold can, therefore, be measured with certainty and exactness at the completion of production. To some, this characteristic probably adds an additional reason why the measurement of income should take place as soon as the gold is ready for market.
3. Not only is gold readily marketable and thus convertible into circulating media, but it is the one recognizable money in international trade. If it is not usable as a medium of exchange within a country, as in the United States since the era of the New Deal, it can, at least, be exchanged for money at the will of the owner of the gold, at a fixed predetermined rate. Income in the form of gold, therefore, meets the additional requirement of some accountants, that it must be cash or near-cash.

The writer reiterates that he considers only the first of these three characteristics of gold as important for the measurement and recognition of income. But the first and third characteristics are, after all, essentially the same. In the first, there is the possibility of exchange, at will, for an amount of circulating media which is approximately known at the time. A fixity of amount for which exchangeable, as in the second of the described income characteristics, simply precludes any change in the monetary value of the commodity in succeeding periods. In other words, there are no speculative possibilities in the retention of this commodity. It is true that, where the possibility of a change in the market price is present and a commodity is held in the hope of an enhancement in value, the final profit on that commodity is not known until it is sold; nevertheless,

the profit up to the date of the accounting cut-off is known, whether that be a profit on productive activity only or on speculative activity as well.

As an indication of the current accounting practice with respect to the stage in the earning process at which income is recognized in the case of gold-mining companies, all such companies which are included in Moody's 1941 ***Industrial Manual*** and which have a total gold and silver production of five million dollars a year were considered. There were twenty companies which were large enough to come within this study, and of these eight[2] do not, it would seem, take income on metal until it is sold, while twelve[3] take income on the metal, by valuing it at realizable value, as soon as production is complete. It was probably not to be expected that the practice would be any more uniform than indicated, since the rule of deferring recognition of income until sale has transpired is so universally emphasized that it is bound to act as a deterring influence.

SUGAR-PRODUCING COMPANIES

A considerable number of sugar-producing companies take profit at the end of the fiscal period on all raw sugar produced, whether sold or not. In the case of such companies, a ready market is available for the disposition of the product, and a market price is, therefore, at hand for the measurement of value and income. This is the first of the three characteristics noted with respect to the marketability of gold. As was noted previously it is the only characteristic necessary, in the writer's opinion, for the recognition of profit immediately on the completion of production or, in other words, on the acquirement of marketability for the product. Under that circumstance a dependable measuring stick of value and income is at hand and it seems proper to use it. In the previous cases of gold and silver mining, it is noteworthy that where profit was taken on gold at completion of production, it was likewise in every case also taken on silver. Yet silver only partakes of the first of the three characteristics mentioned for the marketability of gold (except for the sponsorship and steadiness that our government has lent to the silver market, both domestic and foreign, during the past six years), and it is in this respect similar to raw sugar.

All of the sugar-producing companies for which some financial data are to be found in Moody's Manual (1941) were included in this study. Since the number of companies was comparatively small the elimination of the smaller companies, or the substitution of a sample list of companies was not considered advisable. Two possibilities were considered with respect to the bases for realization of income, sales and production. By sales as a basis is meant that the gross-income item is the amount of product sold during the year and, further, that the inventory does not include an element of gross profit. If the inventory is, as in many cases, priced at realizable figures, then it was assumed by the writer that the profit was taken on production and not on sales, even though the income title might be "Sales." By production as a basis is meant that the profit figure includes the operating results on the raw sugar produced during the period whether it was sold or not. The companies are producers of cane sugar with four exceptions, all located in the United States. The producers of cane sugar commonly have mo-

[2] The companies which use sales as the gross income item are: American Metal Co., Ltd.; Bunker Hill & Sullivan Mining Co.; Cerro De Pasco; Consol. Mining & Smelting Co. of Canada, Ltd.; Golden Cycle Corp.; Hudson Bay Mining Co., Ltd.; Sunshine Mining Co.; and Wright-Hargreaves Mines, Ltd.

[3] The companies which regard production as their income are as follows: Alaska Juneau; Am. Smelting and Ref. Co.; Balatoc Mining Co.; Banquet Consol. Mining Co.; Dome Mines, Ltd.; Hollinger Consol. Gold Mines, Ltd.; Homestake Mining Co.; Lake Shore Mines, Ltd.; McIntyre Porcupine Mines; Norando Mines, Ltd.; Phelps Dodge Corp.; and U. S. Smelting, Ref. & Mining Co.

lasses as a product as well. Usually the molasses follows the same bases for recognition of income as the raw sugar.

These sugar-producing companies were considered with reference to the location of their principal producing territories. For the most part, they are located in three countries: Cuba, Hawaii and the United States. The pertinent accounting data available for the companies located in Hawaii are, for the most part, meager. Eighteen of the fifty companies, better than one third of them, are located in Cuba. Of these, eleven, or more than one half, take profit on all the raw sugar produced during the accounting period. Possibly some of the remaining seven companies do so also, since the assumption of sales basis for these had to be made, with one exception, entirely from the account title. Seventeen companies, or approximately one third of the list, are located in Hawaii. For these, there are inadequate accounting data, insufficient for conclusions as to the stage at which income is booked. In the case of three of the companies, the Hawaiian Commercial and Sugar Company, the McBryde Sugar Company, Ltd., and the Pioneer Mill Company, Ltd., the title of the income item indicates that a cash basis is probably being used. In no case is there any indication for these companies in Hawaii that the income for a period is taken on the total production for that period. The information is correspondingly meager for the two companies located in the Philippine Islands. The four companies located in Puerto Rico all use a production basis. Of the seven companies located in the United States, two use the production basis. One of these, Godchaux Sugars, Inc., even takes a profit on the refined sugar produced as well as the raw sugar, "molasses, syrups, and milk."

MISCELLANEOUS CASES

In at least two other industries there are found companies which take profit on production, prior to sales.[4]

A number of companies in the petroleum industry take profit on the crude oil produced. Moody's 1941 manual was again used in an examination of these financial statements. There are about 150 petroleum companies for which accounting data are provided in this manual. The financial statements of thirty companies were examined.[5] Eight of the thirty take profit on the total crude oil produced rather than the amount sold.[6] Since for thirteen of the thirty, the accounting data are not sufficient to determine for a certainty what basis is used, the proportion that use production as a basis may even be greater than indicated by this sample.[7] Market or realization prices were not always based on the same concept. Thus, the Ohio Oil Company valued its crude oil at the market price as of the dates of production or of purchases. The Plymouth Oil Company used the "average selling prices for the month of December." More commonly, of course, where a definite statement with respect to the market price was given, it was the quoted selling price or approximate or estimated realization figure for the last day of the fiscal period.

[4] The financial statements for all companies on the first 500 pages of Poor's Manual of Industries were first examined for a clue to the specific industries which do to some extent take profit on goods produced rather than sold.

[5] Every fifth company under the Petroleum classification was selected for this study.

[6] The nine companies which take profit on this basis are Crown Petroleum Corp., Lion Oil Refining Co., Margay Oil Co., Midwest Oil Co., Plymouth Oil Co., Superior Oil Corp., Texas Gulf Producing Co., and the Transwestern Oil Co. Although there was no statement to that effect, it was assumed that the Texas Gulf Producing Co. took profit on its entire production rather than sales, since the quantity of crude oil produced multiplied by the given average unit price of crude oil was equal to the figure for "Crude oil revenue," the income item. There was a considerable change in the amount of the inventory from the beginning to the end of the year 1940.

[7] Morland and McKee in *Accounting for the Petroleum Industry* (1925), p. 61, state: "So ready is the market for it (crude petroleum) that the practice of considering oil production as an earning, whether sold or not, has become well established."

Although no statement of explanation or justification was given for the two exceptional methods of pricing, it is, of course, easy to surmise at what the reason might be in each case, from the obvious effect of the method. Where the realization price at the time of the recovery of crude oil is used, there is at least the possibility of a distinct separation between the profit or loss on operation and that on holding or speculation; the profit on the crude oil calculated on the selling quotation at the time of completion of production would, of course, be the operating profit, and the difference between the quotation price and the actual final selling price would, then, be the gross speculative profit or the profit or loss on storing. Another consequence of this method of pricing is the failure to include the speculative profit in the period in which it accrues. The operating profit is accrued but the speculative profit awaits its final determination in sales before it is recorded. It is true that the justification for accruing the operating profit in this case is stronger than that for accruing the speculative profit, since the first is final at the time of accrual while the speculative profit is subject to either enhancement or disappearance up to the time of sale. Nevertheless, it is the writer's opinion that the income statement for a period should reflect all income that is realizable during that period, and that any change which may occur in the next period either to enhance or reduce such realizable figures would then properly be included in the corresponding statement for that period.

The other exceptional method, used by one of the petroleum companies, of pricing the product at the average quoted price for December, has probably as its purpose the elimination of the effect of a possible short-time fluctuation in the price, such as might be true in the customary use of the closing price on December 31. But if an average is to be used, it should be an average for a much shorter period, possibly just an average of the quotations on the last day of the month, December 31, the final day of the accounting period. The financial statements should truly reflect the status on that date. A monthly average might not be even approximately representative of market prices on the last day of the month. The same company, the Plymouth Oil Company, also values gasoline in the same manner, i.e., at realizable value as determined above.

The uniform system of accounts as adopted by the American Petroleum Institute provides for the valuation of inventories at either "cost" or "cost or market basis (whichever is lower)," whether those inventories by crude oil or refined products.[8] This valuation basis precludes, it would seem, recognizing income until the sale transpires. Further than that, instructions under "gross operating income" are quite definite and do not provide for the recognition of income on crude oil on the completion of production. They are quoted herewith insofar as they are thought pertinent to this discussion: "Gross operating income includes . . . sales of crude oil, gas, natural gasoline, refined products and containers."[9] The chart of accounts also seems to indicate very definitely that it is not intended that any income shall be recognized on commodities until the sale takes place:

Gross Operating Income.
Income from Sales of Crude Oil, Gas and Petroleum Products.
Income from Sales of Other Commodities.
Income from Oil, Gas, and Natural Gasoline Royalties
Income from Services.[10]

A description of the content of these accounts which follows in the bulletin leaves

[8] Uniform system of accounts, American Petroleum Institute (1936), p. 8.
[9] *Ibid.*, p. 45.
[10] *Ibid.*, p. 47.

no doubt that the intention is that income shall not be recognized until at the time of the sale.[11]

Some copper-mining companies take profit on the copper produced rather than the amount sold. The statements of all of the copper companies included in Moody's Manual were examined, Of the twenty-nine companies included, six were more or less on a production basis of reporting income. Two of these valued all their unsold copper in the inventory at "market." One valued all unsold copper in the inventory over and above the "Normal Operating Stocks" at market. The "Normal Operating Stocks" were valued at cost. A fourth company took "profit and loss on inventory" but credited the profit on the normal stock to a special reserve, "Metal Stock Reserve." A fifth company valued "Metals on hand and in process," $11,410,292, "net sales price." The statement for this company would seem to indicate that the profit was even taken by this company befor the copper was ready for marketing. A sixth company listed as its income item "Metal recoveries," but, since it had no inventory item in the balance sheet, a production basis may not have been intended. The writer, however, believes that this title for the income item suggested a production basis of income recognition. One of the remaining companies submitted a statement of receipts and expenditures in lieu of an income statement, including loans and assessments among the receipts.

An especially thorough test-check was made of the statements of other mining companies. For instance, the writer examined the statements of all the companies listed in Moody's manual, whose principal product was iron ore, but, in no case was profit taken on production. In no case where lead, zinc, molybdenite, nickel, aluminum, tin or platinum were the principal products, was profit taken on production. It may be remembered that two of the gold and silver mining companies previously listed (Alaska Juneau and American Smelting and Refining Companies) did take profit on their production of lead and zinc. Commonly gold and silver mining companies that also have molybdenite as a product take profit on the production of the latter if they do so on the gold and silver.

THE EFFECT OF RESTRICTIONS OF PRODUCTION ON THE USE OF REALIZABLE VALUE IN THE RECOGNITION OF INCOME

Several of the products which are in the nature of raw materials have been restricted in production by agreement or government regulation during the last fifteen years. These products include coffee, copper, peltroleum, rubber, silk, sugar, tea, tin, wheat, cotton and other agricultural products. The majority of such controls of output began by market intervention, and it was hoped to raise or maintain prices by withholding supplies until the market could absorb them. Such action, however, commonly encouraged production and increased supplies. This situation led to the next step, curtailment of production, which might begin by voluntary restriction but was generally followed by government intervention and regulation.[12]

In the case of copper and tea, control measures have continued to be carried out almost entirely by private international agreements. Production of the other named commodities has become subject to considerable government regulation. The control quite commonly took the form, in whole or part, of a limitation of the quantity produced or of the acreage planted. It might, however, apply to the quantity marketed or only to the quantity exported.

[11] *Ibid.*, pp. 50, 51.

[12] National Industrial Conference Board, Inc., *International Raw Commodity Price Control*, pp. 1–3.

Attempts were sometimes made to exercise the control by establishing a fixed selling price, agreeing not to sell below such price. The control did, in cases, result in two markets: a home market and an export one. One, either the home or export market, might be price-controlled; and the other might receive all the excess supply. In other cases, the excess supply that was not absorbed in the controlled market was destroyed.

Insofar as production only is limited and selling is free, there seems no reason why the profit should not be recognized immediately as soon as the product is ready for marketing. Such control probably tends to stabilize the market; i.e., reduce the possibility of a considerable change in the market quotation. Also, where the interference with the market takes the form of the purchase and storing of the excess supply, the market is as available as ever to the individual producer and the reasons for using market quotations to determine income are as valid as previously. Again, prices will probably be more stable.

If the regulations are such, however, as to provide for two markets—a domestic one for a specified amount of the product and a foreign, for the remainder (or the reverse)—two market prices must obviously be applied; the price in the foreign market, to the quantity to be marketed there, and the price in the domestic market to the quantity available for that market. If there is no such separation of markets but, nevertheless, a limitation on the amount that may be sold but no restriction on the production, a more difficult problem presents itself. The amount on hand, which may be marketed, has a realizable value of the market quotation and should, it seems, be valued accordingly. The value of the remainder would depend on the circumstances. Where the product is such that any remainder has a use value to the producer, it might seem reasonable to estimate such use value, and assign that to the remainder. That value of the residual might then be regarded as a deduction from the cost or an addition to the income—either procedure giving apparently the same net result. If the product has no such use value, but is durable and is stored to meet the quota of the next period, production by the holder for the following period being guided accordingly, it might seem proper to value such leftover product at a discounted cost price.

An example may illustrate what the writer has in mind in the last case. "R" has a production of 100,000 units of a product. His sales quota is 85,000 units, and the market quotation is $1.00 a unit. The cost for the current production period is .60 and the cost is estimated to remain approximately the same during the next year. It is necessary to assume further that "R" will regulate his production to produce approximately 70,000 units the following period, assuming his quota to remain unchanged. This is a reasonable assumption as there is no other way for "R" to give value to the carryover. Further, the cost of storage, insurance and interest is 10¢ a unit. It would seem reasonable, then, to assign 50¢ a unit to the excess, a total of $7,500.00. The income for the period in question would then be determined as follows:

Earnings on production:		
85,000×1.00		85,000
Cost of Production:		
100,000× .60	60,000	
Less:		
15,000× .50	7,500	52,500
Net Operating Profit		32,500

If the probability of spoilage or the cost of carrying necessitates destruction or other disposal of the excess, then not only would the entire cost have to be assigned to the quantity marketable, but any cost of disposal of the excess product would be an addition.

The writer maintains that utilization of market quotations in recognizing income on the completion of production is not usually seriously affected by artificial restrictions imposed on either the production or marketing activities.

It is believed that the utilization of market quotations to measure income on the product might well be considerably extended. Such extension, however, is seriously limited by the rigidity of income-tax regulations in this country and the prejudice of accountants in general. An undue emphasis has been placed on "the sale," to the exclusion of other possible tests. Where there is a ready market for the product of a company, and the company's production is not so large that its selling operations will seriously affect the price quotation, then a measurement of income is available as soon as the product is ready for marketing. For most of the products of agriculture and mining such markets are available. There is, therefore, not only the possibility of a further use of this test of income within the few industries in which the writer found it used, but it might properly be adopted by companies in other industries which also have ready markets for their products.

If a company's production is so large that the product must be marketed gradually over a period in order not to depress prices, the justification for the use of this test is not as clear. The amount of cash that might be had for the entire product is not known, and the possibility of turning the product into cash immediately is not present. It is believed that a reasonable solution, in such a case, is to recognize the income only on a part of the product—the amount that might be marketed, according to estimates, within a few days without noticeably affecting the quoted price. The remaining product would, then, be valued at cost; the recognition of the profit on this remainder of the inventory would, under such a procedure, be deferred until the following period.

DEPRECIATION POLICY: REPAIRS AND REPLACEMENTS

Carl Devine

Accountants writing in the field of depreciation, particularly with regard to repairs, renewals, replacements, betterments, etc., have placed what seems to the present writer undue emphasis on the physical and productive aspects of the problem.[1] Such criteria for accounting procedures, while of some benefit, do not offer a rational basis for the solution of many accounting difficulties which arise in this field. There are cases, no doubt, in which the replacing of a simple rivet or bolt (a "renewal"—usually considered an "ordinary" repair) will increase the productivity of a complicated machine from zero to one hundred per cent. Moreover, the fact that an "extraordinary" repair will probably increase the service life of the entire machine or make the unit perform more efficiently, while of critical importance in guiding the management in reaching the decision to make the change, ordinarily does not constitute a rational basis for determining whether the expen-

[1] A notable exception in the earlier literature may be found in Paton, W. A., and Stevenson, R. A., ***Principles of Accounting*** (New York, The Macmillan Company, 1921) pp. 485–491.

diture should be taken to operations in the period of incurrment or deferred (partially at least) to future operations. Upon what basis, then, should the accountant make this important decision, which so vitally affects the determination of periodic income?

For many years it has been recognized in practical affairs that the distinction between renewal repairs and replacement is arbitrary—the two are in fact the same until a cleavage is forced by the adoption of a depreciating unit consisting of heterogeneous components.[2] (There are, of course, "repairs" which are not properly considered replacements, e.g., valve grinding, but this type of repair ordinarily presents few accounting difficulties other than the question as to the desirability of using an equalization reserve for its distribution.) The need for such a distinction arises because the depreciating asset is so broad that the charge to operations is calculated on a complex of physical properties whose components are estimated to have varying lengths of life—the depreciation charge is a composite. A rational approach to accounting for retirements, repairs, replacements, additions, etc., would seem to begin with a careful analysis of the components of the composite asset and of the elements whose varying lives enter into the periodic depreciation charge.

In general the smaller the depreciating unit the more accurate the replacement accounting and the more unimportant the factor of repairs, though it is not size *per se* but homogeneity which is important in this connection. Suppose, for example, that plant records are so detailed that separate accounts are kept for each brick, each pane of glass, each girder, each unit of flooring. It is clear that for such a situation the problem of repairs and replacement is clear-cut and unambiguous. For a less extreme example suppose that each accounting "unit" is somewhat broader but all components of the unit are homogeneous in that each may be expected to have the same useful life. In this case the total depreciation taken against the accounting unit may be allocated over the smaller parts according to relative costs and the orthodox retirement procedure followed with respect to each minor item. Since in practice the individual parts are likely to have somewhat different lives, the accounting classification is often extended to include items which are identical except for service life expectancy. If the items are numerous enough, the individual expirations may be assumed to follow a curve of normal expectancy, and the "group" method of depreciation applied. This procedure requires the treatment of each item as fully depreciated when it is retired, regardless of its actual service life. Since the life used in setting the accounting depreciation rate is the expected average, it may be assumed that the retired components lacking accrued depreciation equal to their cost will be roughly equivalent to those having accumulated depreciation in excess of their cost. It is not with these relatively simple cases that we are now concerned, for tradition accounting treatment is usually satisfactory in these areas.

The real difficulty, and the one most often encountered in accounting, arises when the accounting unit is made up of components having differing life expectancies and also varying costs. Suppose, as a basis for discussion, that the depreciating unit is taken to be the unit of delivery equipment—the delivery truck. A vehicle of this sort is clearly composed of many items having, under ordinary circumstances, widely differing service lives. As a practical procedure it is impossible to ac-

[2] ". . . all acts of repairs are in their essential nature replacements." Williston Fish, "The Depreciation Reserve Fund," Abstract in *Electric Railway Journal*, January 31, 1920. Quoted from Perry Mason, *Principles of Public-Utility Depreciation*, (Chicago, American Accounting Association, 1937), p. 22.

count for depreciation on each part of the complex mechanism, and it is ordinarily not unreasonable to treat the entire truck as the depreciating unit. The problem is further complicated by the fact that the price of the delivered truck is considerably less than the sum of the prices for its parts.[3] A careful allocation of the original cost of the total product to the individual parts is, of course, a difficult task calling for assumptions of a highly questionable character. As will be pointed out later, the treatment of all replacements as repairs, combined with an equalization reserve, permits the accountant to evade this difficult assignment. Numerous part of the delivery truck may be expected to last as long as the operating unit, and these items may be grouped together with respect to cost distribution. Here, as elsewhere in accounting, the accountant is beset with the difficulty of forecasting within reasonable limits of error the life of the entire unit and its parts. It goes without saying that such estimates assume a given level of maintenance and upkeep.

It should be clear that the *rate* to be used for the entire depreciating unit is a composite—an average weighted by assigned costs—based on individual life and scrap estimates of the parts and also on the estimated residual value of each retired part and of the entire product. It is only when this composite is calculated with some care that the accountant may proceed to the retirement of the component parts and their replacement with assurance that his distinction between repairs and replacements can be logically defended. Thus, if replacement of an item were contemplated and its estimated life used in the setting of the composite rate, it should be treated by the retirement-replacement procedure. Presumably when this is carefully done, it is possible to determine the "loss" or "gain" on each component part. If, on the other hand, the item were considered too insignificant for inclusion in the composite rate some other treatment seems indicated—the need for a "repair" category has now arisen. Perhaps the most important practical lesson to be derived from the above discussion is that the rate to be applied to a complex structure need not, and in fact ordinarily should not, be computed on the length of expected life and the anticipated residual value of the entire structure; the rate should be modified for the number of items whose replacements are going to be considered through the retirement-replacement procedure.

The "ordinary" repair, then, turns out to be the replacement of items whose differing lives were *not* considered in setting the composite depreciation rate, i.e., the periodic charge for depreciation was not calculated to cover these items.[4] Unfortunately, however, the orthodox treatment of ordinary repairs leaves something to be desired. Traditional practice includes the total initial cost as depreciating asset and treats minor replacements (ordinary rerepairs as defined above) as expenses of the periods in which they are incurred. Often such a procedure leads to reasonable results, and many instances in practice may be treated in this manner without objectionable effects. Before this simple means of handling repairs can be considered acceptable, one of two conditions must be fulfilled: the amounts of such repairs must be so small that their net effect on the broad income stream is inconsequential or they must be incurred with enough regularity to accomplish the same result. In

[3] This difficulty has been pointed out by Paton in his *Advanced Accounting*, (New York, The Macmillan Company, 1941), p. 222.

[4] The use of "ordinary" and "extraordinary" in the traditional manner in regard to repairs appears to be unfortunate. In fact, the "extraordinary" repairs turn out to be so ordinary that the possibility of their being made before the retirement of the larger unit is given explicit consideration in determining the composite depreciation rate.

practice, nevertheless, repairs are often expensed when neither of the above requirements is met. For example, painting, papering, plastering, etc., when necessary for rented property are often taken to operations when incurred. Such items in relation to the income to be expected from the property in one period are not negligible. Furthermore, except for complex properties, these items seldom "average out" over the accounting periods. There is no reasonable basis, certainly, for charging every fifth year with the painting cost of a warehouse and permitting the intervening four years to bear no painting expense. To argue that it is the fifth year in which the expense was incurred is completely beside the point—the period of expenditure has no necessary connection with the periods to be charged with the expense.

It should be noticed, moreover, that the ordinary repair procedure includes the costs reasonably assignable to the items whose replacements are to be considered repairs in the original cost of the depreciating asset and writes them off through the depreciation charges. This procedure has the practical advantage of rendering unnecessary the arbitrary assignment of the *total original* cost to these items, but it should be observed that the actual period in which the "replacement repair" is made is stuck with, not only the costs attaching to the new item but also, a part of the write off of the original item through the depreciation charge for that period. To compensate for this obvious unfairness the technique of distributive reserves—ordinarily equalization reserves—may be applied.

The well-nigh impossible task of allocating the total original cost to the individual parts deserves further attention. True, the total cost may be apportioned according to the relative costs of each item (if purchased separately) to the total cost if each item had been purchased individually, but such calculations are often difficult if not practically impossible. The necessity of allocating the total original cost between the component parts, as has been seen, may be overcome by making the assumption that all original parts for purposes of calculation have the same life—the life of the entire unit. That is to say, *all* replacements short of the entire unit may be estimated and treated by the "repair" procedure, and equalization or other distribution reserves used to allocate the anticipated cost of replacements to the various periods.

Nevertheless, a slight complication arises in connection with the reserve technique when applied to this problem. If the expected replacement cost of a part is higher than the original cost, the earlier periods are charged with some of the anticipated extra cost of replacement. The total long-run expected capital cost of the asset is thus distributed (perhaps equalized) over the periods in spite of the fact that the cost of the original asset is less than the cost of similar facilities in the future. It may be said to be less, since it is reasonable to assume that the cost of the individual parts needed in the future will be higher than the part of the original total cost which may be imputed to them. From the long-run point of view it seems rational to hold that the total charges for a particular machine be apportioned over the periods in proportion to the benefits each period receives from the asset. It is true, of course, that such "average" calculations are not of great benefit in reaching decisions regarding abandonment and replacement of the total unit, but ordinary accounting records are also of little use in this regard. Supplementary calculations based on productivity estimates, interest rates, direct cost saving, depreciation on the new equipment (and depreciation involved in the decrease in residual value due to continuing the operation of the old) are required for an intelligent handling of this problem.

To conclude this part of the discussion, repairs and replacements may be accounted for in two somewhat different ways. In the fixing of the depreciation rate the component elements may be carefully sorted into those which are to be included in the determination and those which are not to be included. Those omitted, upon replacement, will be treated as repairs and the others will be handled by the retirement-replacement method. An alternative procedure, which avoids the necessity of assigning the original cost to the various elements, treats all replacements short of the entire unit as repairs and allocates these charges to the periods by the use of reserves. To attempt the use physical or productivity tests in deciding whether an item should be taken to operations upon incurrence in disregard for the nature of the depreciation charge seems to be without defense.

II

The irregular procedure, sometimes advocated in accounting textbooks and manuals, of charging replacements to the Reserve for Depreciation depends for justification not only upon the accuracy of the above division of replacements and repairs but also upon the questionable assumption that the composite depreciation includes an amount for each item exactly equal to the replacement cost of each item.[5] Another objection has been advanced against the charging of replacement units to the account with depreciation reserves. To the extent that replacement costs are not identical with the imputed original cost, the plant account loses its relation to the actual cost of existing facilities.[6] Perhaps the most interesting consequence of this effect is the change in estimated life of the composite which is implied by the application of this procedure. For an example, suppose the depreciating unit is composed of two items, A and B. A originally cost $3,000 and has an estimated life of 10 years; B cost $2,000 and has an estimated life of 5 years. At the end of 5 years B is retired as contemplated and is replaced by an identical unit costing $3,000. (It should be noticed that in times of rapidly rising prices or of premature retirements it is possible to have a debit balance in the allowance for depreciation account. If this were the case, it is clear that the allowance account is an adjunct to the understated cost of the asset.) The original composite rate—neglecting residual values—is 14%, but when the cost of the "replacement" is charged to the reserve account, the application of this rate to the purported "cost" of the depreciating unit implies a total life of 11$\frac{3}{7}$ years. If the increase in cost were a "betterment," such an automatic extension of service life may be reasonable, but where the difference in cost is due to price changes, the automatic rule yields absurd results. In view of the many considerations entering into the cost of rements, it seems little is to be gained by shifting estimated service life through an arbitrary rule which is related to only one of many patent considerations.

The other assumption underlying the recommendation to charge replacement costs to the allowances for depreciation—that the accumulated balance exactly equals the replacement cost of the item—is thoroughly unreasonable. In the first place, there is no reason why the accrued depreciation should be equal to the *replacement* cost, and in fact there is little reason to hope that it will be exactly equal

[5] Gilman states: "There are those who believe that such repairs should be charged against the reserve for depreciation on the theory that the life of the asset has been increased, a theory which holds water only if such treatment were contemplated in the original establishment of the depreciation program."—*Accounting Concepts of Profit*, (New York, The Ronald Press Company, 1939), p. 495.

[6] W. A. Paton, *Advanced Accounting*, (New York, The Macmillan Company, 1941), p. 222.

to the cost of the original unit. Even for the latter estimate such transactions typically involve an element of "loss" or "gain." Accounting for such balancing amounts deserves attention, particularly in view of the rather unsatisfactory manner in which they are sometimes handled in practice. Such a discussion may well be inaugurated by posing the question: What is the nature of these losses and gains?[7]

While it may be argued that the period of disposal deserves credit for these gains (or discredit for the losses) since the series of events came to a head in this period, such a position is in many cases untenable. For the typical situation disposition of depreciable assets does not give rise to opportunities for unusual bargaining advantage. Thus, it appears unwarranted to assume that the "entrepreurial effort" exerted in this period is of enough importance to justify recognition of the entire gain or loss in the period of disposal. There are, of course, exceptions. Suppose, for example, that a truck purchased in the current period and wrecked without insurance in this period is turned in at a loss. Clearly the acts leading to the loss, i.e., the negligent driving, the failure to carry adequate insurance (unless this is a previously established policy), etc., are managerial judgments made during the current interval, and it seems reasonable to insist that this interval stand the loss. Where the considerations clearly attributable to the current period are recognizable with the clarity required for reasonable estimation, this period should be charged (or credited) with a portion of the "loss" (gain) involved.

In many cases, nevertheless, it is clear that the adjustment at disposal is necessary because of poor estimation of the depreciation to be charged to periodic operations. Had the accountant had perfect foresight, there would have been no discrepancy. The so-called loss in the period of retirement is a peculiar item—it is a correction of overstated profits of previous periods' profits.[8] Conversely, a gain on disposal is often a correction of previously understated income.

It is sometimes argued that any balancing amounts of this nature are not losses or gains, but, it is asserted, they are legitimate additions to or deductions from the cost of new facilities. Although the Treasury Department has insisted on this procedure in certain exchange transactions for purposes of determining taxable income, most accountants agree that its general adoption is not to be recommended in connection with reported income.[9] With respect to individual items, some may be depreciated too rapidly while others are sometimes under-depreciated. This is, of course, true, but is there any reason to expect them to "average out" during the periods and over the life of the composite? In some cases reasonable results may be expected, but often the entire depreciation program is over- or under-optimistic, and where general errors of estimate are a distinct possibility, the more careful and more laborious method is indicated. (This possi-

[7] Certainly our concept of loss is not clarified by Mr. Avery's statement: "If the cost of the old boiler was depreciated to the extent of \$2,400, the expenditure of \$6,000 for the new boiler provides for three things: \$2,400 for the depreciated value of the old boiler (a replacement), *\$600 for the loss on retirement* of the old asset, and \$3,000 for the improvement in plant facilities (betterment)."—"Capital and Revenue Expenditures," THE ACCOUNTING REVIEW, September, 1941, p. 277. (Italics added.) The cost of the original boiler was \$3,000.

[8] Since the publication of "A Tentative Statement of Accounting Principles," it has become fashionable in some quarters to deny the utility of surplus adjustments. The dangers which may result from direct adjustments to surplus may be resolved into offenses to the doctrine of full disclosure. It should be remembered that the "income sheet" of Mr. Paton and his followers is a combination profit-and-loss statement and statement of surplus. *An Introduction to Corporate Accounting Standards* (pp. 98–102) does much to clear up these points.

[9] See, for example, W. A. Paton, *Advanced Accounting*, p. 319, and Stephen Gilman, *Accounting Concepts of Profit*, pp. 531–532.

bility of general over- or under-estimation is a factor applying also to the "group" method of depreciation.) The compromise here, as elsewhere in accounting, is between practical expediency and exacting analysis.

WHAT IS AN INDEPENDENT ACCOUNTANT?

Richard N. Owens

The requirement that financial statements prepared in connection with issue of securities be certified by an independent accountant was incorporated in the Securities Act of 1933. The Act provides that a detailed balance sheet certified by an independent public or certified accountant of a recent date must be submitted as a part of the registration statement. A profit-and-loss statement similarly certified must also be submitted, showing expenses and income for the latest fiscal year of the registrant and for each of the two preceding fiscal years. If the date of filing the registration statement is more than six months after the close of the last fiscal year, a statement must be submitted covering the period from the close of the fiscal year to the date of the most recent balance sheet filed.

THE IMPORTANCE OF THE INDEPENDENT ACCOUNTANT

If he is to discharge his obligations to the public, the accountant who certifies the financial reports must be independent because the reports are largely a matter of considered opinion. To perform his function of certifying the balance sheet and the statement of profit and loss, the accountant must investigate the financial condition of the company from a detached and independent point of view. Otherwise he might unconsciously or perhaps consciously permit his own personal interests to affect the statements which he certifies; and he might mislead present and prospective securityholders not only by the value assigned to the various items appearing in the statements but also by their form and arrangements and by failure to present the information in sufficient detail.

In commenting upon the importance of the periodic review of the accounting records and statements by outside experts, a committee of the American Institute of Accountants has pointed out that the financial statements represent the judgments of the management of the company in the application of conventional methods of stating assets and liabilities and in appropriate allocations of income and outgo items to specific periods of time. It is the function of the accountant to see that these numerous judgments have been made in accordance with accepted accounting principles consistently followed by the company. If he does not concur in the results of the judgments, he must take exception by asking that the statements be changed or by stating his opinion in a footnote appended to the statements or in his certificate.[1]

The Securities and Exchange Commission holds that the independence of the accountant is of very great importance. In the case of the Cornucopia Gold Mines,[2] the Commission expressed its disagreement with the contention of the registrant

[1] See Report of Subcommittee, *Journal of Accountancy*, Vol. 68, p. 236, 237. Oct., 1939.
[2] SEC Decisions 1: 367. March 28, 1936.

that certification is merely a "tag" attached to the financial statements and that its only significance is to direct attention to them, to induce reliance upon them, and to guarantee their propriety. Certification, in the opinion of the Commission, is a material fact, signifying that "the contents of the financial statements to which it is appended have been checked and verified within the limits stated by the certificate." The purpose is to assure that the accounting practices and policies of the registrant will be submitted to an independent and impartial mind and to protect present and prospective security holders against unsound accounting practices and procedures. Independent certification gives a minimum protection against untruths and half-truths which otherwise would more easily creep into the financial statements. Independent certification is too important to be dismissed as a mere "tag."

WHEN THE ACCOUNTANT IS NOT INDEPENDENT

There are several circumstances which may destroy the independence of the accountant. The first is the ownership of stock in the company for whom the statements are being prepared. The principal question here is the amount of stock which the accountant must own before it may be assumed that he is not independent. In the case of the Rickard Ramore Gold Mines, Ltd.,[3] the accountant certifying the balance sheet owned 11,000 shares of stock of the registrant, of which 10,000 shares represented remuneration paid to him for accounting services rendered in connection with the formation of the company. The total authorized capital stock of the company was 3,000,000 shares with a par value of $1 per share. Of this amount, 1,500,000 shares had been issued at the time the company was organized, 500,000 shares had subsequently been sold to the public through the underwriters, and the company indicated in its registration statement that it intended to issue the rest of the stock. The Commission held that the accountant was a substantial stockholder in the issuer and would be inclined to approach its accounting problems as a stockholder rather than as an independent accountant. It was pointed out that the stock would be likely to increase in value if the balance sheet was prepared in such form that it would induce investors to purchase additional stock at high prices and thus to supply the funds necessary to the development of the mining claims of the company.

When the Commission cited as a deficiency in the registration statement the fact that the accountant certifying the balance sheet was not independent, the Rickard Ramore Gold Mines company filed a new balance sheet certified jointly by the accountant who had certified the first statement and by one of his employees and associates. This was not enough, however, to make the certification that of an independent accountant, since the Commission held that an employee or a partner of the stockholder-accountant would be influenced by the relationship. If an accountant is disqualified because of his ownership of stock, his partners and employees may likewise be disqualified.

The amount of stock ownership necessary to disqualify an accountant with regard to his independence may be determined by a comparison of the value of his stock either with his total personal holdings or with the total outstanding stock of the corporation. An accountant cannot be deemed to be independent if he holds an interest in the registrant that is significant with respect to his personal holdings. In one case the Commission based its decision upon the fact that the value of the ac-

[3] SEC Decisions 2: 377. June 16, 1937.

countant's holdings constituted more than one per cent of his personal fortune.[4]

Closely related to the ownership of stock by the accountant is the situation where a relative of the accountant owns stock in the company or is otherwise connected with it. For example, the council of the American Institute of Accountants recently heard a complaint against two members, in which it was alleged that stock of the client corporation was held by the wives of the accountants, that loans to its officers had been made by the accountants themselves, and that the accountants in turn had at times borrowed money from the officers of the company.[5] At the trial, it was disclosed that the amount of stock held by the wives of the accountants was insignificant in proportion to the total outstanding stock of the company though at different times it amounted to 1½% to 9% of the combined personal fortunes of the accountants and their wives. It was shown also that the loans were personal in nature, were small in amount, and were outstanding for relatively short periods of time. For these reasons, the council concluded that the accountants were not guilty of conduct discreditable to the profession but it warned that in the future it intended to apply more strictly the provisions of the existing rules of conduct relating to financial interest of the accountant in the client corporation.

A second cause of lack of independence on the part of the accountant is that he may be an employee of the corporation for whom the statements are being prepared. According to Rule 650 of the General Rules and Regulations of the Commission, an accountant is not independent if he is connected with the registrant as an officer, employee, promoter, underwriter, trustee, partner, director, or person performing similar functions. In the case of the Cornucopia Gold Mines,[6] the two accountants who signed the registration statement had entered into a contract with the registrant which provided that they were to receive $5,000 per annum plus one per cent of the gross metal sales for each year. Their duties included the installation of an accounting system, the making of audits, and the furnishing of office space for the use of the corporation. It was also disclosed that the accountants had no contracts of this kind with any other company, the rest of their contracts being on a fixed-fee basis. To carry out the terms of the contract, an employee of the accountants was made the comptroller of the corporation at a salary fixed and paid by the accountants. As comptroller, this employee of the accountants assumed control of the accounting office of the corporation, wrote and signed letters in the name of the corporation, and acted as co-signer of its checks. The reports of the corporation were prepared by the comptroller acting as the representative of his employers, the accountants, who claimed to be independent. The comptroller further disqualified himself as an independent accountant by acquiring stock in the corporation. In holding that the comptroller was not an independent accountant, the Commission stated:

"It would be unreasonable to suppose that he could cast aside these relationships and view the accounting problems with the objectivity of an independent accountant, criticizing and correcting accounting practices and methods of the corporation's own staff, for in making an audit he would in fact be partly reviewing his own work. Hence, in this case he cannot rid himself of the disabilities inherent in his office of comptroller and in his status of a stockholder of the registrant, when, as an em-

[4] SEC Accounting Series, Release No. 2, May 6, 1937. See also Regulation S-X, Rule 2.01.

[5] *Journal of Accountancy*, Vol. 72: p. 89. July, 1941.

[6] SEC Decisions 1: 365. March 28, 1936.

ployee of White and Currie, he prepares or participates in the preparation of the accounting and audit."[7]

The contract between the accountants and the company further served to disqualify the accountants as independent because they were to receive a percentage of the net sales. This gave them a continuing pecuniary interest in the registrant for the term of their contract. Such an interest, in the opinion of the Commission, would not disqualify an accountant provided it was so small or so indirect as not to give rise to an inference that the accountant might lose his unbiased point of view. A claim to one per cent of the gross sales, however, was held to be so large as to be substantial and material. The holder of such a claim, said the Commission, has too close an identity with the financial destinies and too intimate a personal concern with the managerial policies of the enterprise to bring to bear in his accounting work the objectivity which is the essence of the independent accountant.

In the third place, an accountant may be disqualified as independent if he has maintained personal and financial relations with the officers of the corporation whose statements he certifies. Thus, the Commission held that the accountants of A. Hollander and Son, Inc.,[8] were not independent because the senior partner of the accounting firm had had close personal and financial relations with the officers and directors of the registrant. Just what these relations were was not stated, but they were said to be not consistent with his duties as auditor. However, this was not the only reason for disqualifying the auditor in that case.

A fourth circumstance which may disqualify an accountant on the basis of lack of independence is his employment by the corporation on a contingent-fee basis. Thus, if the payment or the amount of the fee of the accountant is dependent upon the granting of a loan by a bank to which the financial statements are submitted or upon the acceptance of the registration statement prepared by him in connection with the registration of securities, or upon any similar contingency, he would cease to be independent. In the case of the Great Dike Gold Mines, Inc.,[9] the accountant was employed to prepare the financial statements on a contingent fee basis. Whether he was influenced by his contract cannot be determined; but it was found he had included mining properties in the balance sheet at their appraised value with no effort to determine whether such values were reasonable except to read portions of the appraisal reports which were in fact subject to serious question. Development work of no value was shown as an asset with an offsetting credit to capital surplus. Stock which a promoter had promised to return to the corporation was listed as treasury stock although the stock had not actually been returned. Organization expense was listed at an excessive valuation.

In the fifth place, the accountant is not independent if he has entered into a contract with the client corporation under the terms of which he is to be indemnified by the corporation for any losses, claims, damages or liabilities arising from the filing of false or misleading statements. This situation was discussed by the chief accountant of the Securities and Exchange Commission in Accounting Release No. 22 under date of March 14, 1941, which said:

> When an accountant and his client, directly or through an affiliate, have entered into an agreement of indemnity which seeks to assure the accountant immunity from liability for his own negligent acts, whether of omission or commission, it is my opinion that one of the major stimuli to objective and unbiased consideration of the prob-

[7] *Ibid.*, p. 366.

[8] Securities Exchange Act Release 2314. Nov. 24, 1939.

[9] SEC Decisions 1: 618. Aug. 3, 1936.

lems encountered in a particular engagement is removed or greatly weakened. Such condition must frequently induce a departure from the standards of objectivity and impartiality which the concept of independence implies.

An interesting question arises as to whether an accountant who has entered into a contract with an insurance company whereby he is protected from liability either to the client for losses on embezzlement not detected by him or to creditors and security holders for misleading statements also loses his independence. Such contracts have become more common in recent years because of the increasing liability of accountants under state and Federal laws and the changed attitude of the courts.[10] If a contract with the client which frees the accountant from liability may induce a departure from the standards of impartiality, then a similar contract with an insurance company may have a like effect. However, there is one important difference. The client corporation may be willing to assume the risks attendant upon the preparation of misleading statements in order that it may publish its statements in the form it wishes, whereas an insurance company would be desirous only of avoiding unnecessary risks. Moreover, an accountant who caused a loss to an insurance company under the policy might find himself unable to procure such protection in the future.

A sixth type of case where the independence of the accountant is affected is where he consciously falsifies the facts in order to please the client. If he does so, an absence of independence might reasonably be inferred. In the words of the Commission, "he who, as a result of connivance with, or loyalty or subservience to his client, purposely or recklessly misrepresents the facts, cannot be said to qualify as an independent expert."[11] Thus, in the case of the American Terminals and Transit Company, it was shown that the amount of bank overdraft was transferred from the liability side of the balance sheet to the asset side, where it was shown as cash. In order to bring the balanace sheet back into balance, the amount of the accounts receivable was arbitrarily reduced. In the same balance sheet, properties leased with an option to buy were shown as assets without any indication that they were not owned in fee simple. The financial statements were also deficient in many other respects.

In the case of the Metropolitan Personal Loan Company,[12] the accountants who certified the statements completely subordinated their own judgment to the desires of the client. In fact, one of the accountants testified before the Commission that he was not sure what the function of the accountant was and that he generally did what his clients requested. He stated that certain entries which had been made by the company were improper but that he allowed them because the officers had ordered them to be made. He accepted statements of the officers as to the worth of securities and other assets with little or no investigation, and he admitted that he exercised no independent judgment with respect to the adequacy of the reserves for losses on accounts receivable. The Commission also criticized the accountant of the Republic Company[13] who said that he felt obliged to follow the direction of the management. The accountant added, however, that he thought the accounting procedure of the company was proper.

A neglect on the part of the accountants was observed in the case of the Monroe

[10] See A. L. Blume, "The Increasing Hazards in the Practice of Accountancy," *Journal of Accountancy*, Vol. 71: pp. 206–215. March, 1941.

[11] In the Matter of American Terminals and Transit Co., SEC Decisions 1: 707. Sept. 29, 1936.

[12] SEC Decisions 2: 803. Oct. 28, 1937.

[13] Securities Act Release No. 2206. March 14, 1940. SEC Decisions 6: 1062.

Loan Society.[14] They included as loans made by the branch the amount reported to the main office by the branch itself without any investigation or confirmation. It was subsequently disclosed that defalcations at the branch had occurred in the amount of half a million dollars, the amount of cash shortage being reported as fictitious loans. The losses represented about 25% of the total assets of the company and 83% of the assets at the branch. In this case the accountants testified that they had considered the examination of the branch accounts both desirable and necessary and had so informed the officers on numerous occasions. They had not insisted upon such an examination because they were reasonably satisfied that the system of internal check followed by the company was adequate.

A lack of independence on the part of the accountant might also be inferred where he certifies statements prepared from fragmentary and inadequate records without full disclosure of the facts. Thus, in the case of the Sunbeam Gold Mines Company,[15] the accountant prepared the financial statements from check book stubs, deposit slips, and personal records. Transactions of the registrant were not always distinguished from those of its affiliate, or of predecessor companies. Transactions during the preorganization status were not carefully distinguished from those occurring after the company was organized. The accountant who certified the statements thus prepared declared that the accounting principles and procedures followed by the company and its affiliate were in accord with sound accounting principles. However, an accountant who later examined the statements and records declared that it was impossible to certify that the records were kept in accordance with accepted accounting principles because they had not been kept at all. The records themselves, he said, from an auditing standpoint were almost valueless.

In the case of the Platora Gold Mines, Inc.,[17] the company was without records except for a stock certificate book which the accountant did not see, and a minute book which had been rewritten because the original had been lost. The accountant relied in part upon canceled checks, agreements, and vouchers, but largely upon representations by the officers of the company. Some of the statements of officers were substantiated by evidence and others were not. In another case, that of the Sunset Gold Fields, Inc.,[18] the accountants were informed that the records had been destroyed by a flood, and they were compelled to rely upon the memory of the officers for information as to the costs of various assets, including organization and development expenses. The Commission found the statements misleading in a number of respects but did not find it necessary to decide whether the errors were due to deliberate misstatements. It did refer to the flood as "the supposed flood."

Probably the greatest question of independence arises where there is an omission of auditing procedures which accountants would ordinarily employ in the course of the regular annual audit. Thus in the case of the Monroe Loan Society previously referred to, the accountants neglected to visit any of the branch offices of the company and no collateral was examined because of the limited time before the meeting of the board of directors when the statements were to be submitted. Although most of the assets were of the kind which could readily be pledged to secure

[14] SEC Decisions 3: 407. May 15, 1938.

[15] SEC Decisions 3: 299. April 1, 1938. See also In the Matter of National Boston Montana Mines, SEC Decisions 2: 226, 249. April 28, 1937.

[16] See also in the Matter of National Electric Signal Company, Securities Act Release No. 2387. Nov. 6, 1940.

[17] Securities Act Release No. 1807. Sept. 19, 1938. SEC Decisions 3: 872.

[18] SEC Decisions 2: 329. May 20, 1937.

a loan or could even be converted directly into cash, the accountants failed to verify them. They testified that they checked adding-machine tapes previously prepared by the employees of the company but did not re-add them to determine their accuracy.

In many other cases the Commission found that accountants failed to make adequate investigation before certifying financial statements. In the case of the Big Wedge Gold Mining Company,[19] the accountant had examined nothing more than the papers and documents filed with the registration statement itself. In the balance sheet of the Petersen Engine Company,[20] the accountant set up a large amount for development and experimental expenses as a deferred charge without any attempt to determine the amount which had been expended by the registrant and its predecessor companies. The accountant for the Franco Mining Corporation[21] gave an unqualified certificate although he had seen neither books nor vouchers of the company but had relied upon affidavits submitted to him by the officers. The accountant for the Lewis American Airways[22] failed to make sufficient investigation to determine how much of certain expenditures should be allocated to traveling expense, a profit and loss item, and how much to stock selling expenses, a balance-sheet item.

The preparation of a deficient report by an accountant, however, does not necessarily mean that the accountant is not independent. For example, in the case of the American Tung Grove Developments, Inc.,[23] the Commission held that even though the accountant had made only a superficial examination, had failed to disclose the registrant's questionable accounting practices, and had ignored the Commission's regulations concerning financial statements, the effect was merely to make his report unsatisfactory. The Commission did not question the independence of the accountant. It seems that the Commission is on safer ground in a case of this kind in holding that misleading statements are not satisfactory rather than that they prove any lack of independence.[24]

The independence of the accountant may be affected by a combination of two or more of the relationships with the client previously referred to; and if his independence is challenged on the basis of one significant fact, other less important factors may be considered as substantiating evidence. For example, the accountants of A. Hollander and Son, Inc.,[25] were held not to be independent because of the cumulative effect of the following facts:

1) The accountants' financial statements were deficient in several important respects. However, this in itself was held not to establish a lack of independence.

2) The accountants and their wives held substantial amounts of the client's stock. In this case, the stock owned by the accountants was added to that held by their wives, and the total was stated as a percentage of the combined net worth of the accountants and members of their immediate families. The percentage for each year was as follows: 1935, ½ of 1%; 1936, 1½%; 1947, 9%; 1938, 2½%; 1939, 2%; 1940, none. The ownership of stock was held to preclude the independence of the accountants in 1936, 1937, and 1938.

3) One of the accountants had effected transactions for the principal stockholders of the client through various brokerage

[19] SEC Decisions 1: 98, 108. April 4, 1935.
[20] SEC Decisions 2: 893. Dec. 2, 1937.
[21] SEC Decisions 1: 285, 289. Feb. 1, 1936.
[22] SEC Decisions 1: 330, 341. March 27. 1936.
[23] Securities Act Release No. 2361. Sept. 30, 1940.

[24] For a similar decision see In the Matter of the Republic Corporation, Securities Act Release No. 2206. March 14, 1940. SEC Decisions 6: 1062.

[25] Securities Act Release No. 2777. Feb. 6, 1941; this case has already been commented on (p. 393). Also Securities Exchange Act Release No. 2314. Nov. 24, 1939.

houses. Such transactions were also carried out in the name of the accountants for another company owned and controlled by the principal stockholders of the client corporation. The purpose was to conceal the market operations in the stock.

4) Loans were made by the principal stockholders to the accountants and at times by the accountants to the principal stockholders.

5) The accountants and the principal stockholders were fellow members of various civic, fraternal, and social organizations and had been associated in numerous charity and other drives. The accountants and the stockholders of the client had joined in signing a bond to secure a mortgage on a clubhouse. The accountants had also performed numerous personal services for the stockholders, including preparation of their personal income-tax returns, auditing their books, and preparing financial statements for their personal ventures. These relationships, however, were held to be a result of the confidence placed in the accountants by the stockholders and not an indication of lack of independence.

6) The disbursement of money for the client's stockholders, the sale of securities for them pursuant to their specific instructions, the acceptance of legal ownership of shares of the client's stock belonging to the principal stockholders, and the exercise of rights to subscribe to additional shares in the client by the accountants were held to be significant relationships in their cumulative effect.

In most cases of inadequate disclosure, the responsibility should be placed upon the officers rather than upon the accountants. In fact in the case of the Breeze Corporations, Inc.,[26] where no disclosure was made of the writing up of certain assets by the registrant and the predecessor companies, the Commission stated that responsibility lay entirely with the officers and directors who had not furnished the accountants with complete information. The accountants testified that if they had known of the facts when their report was prepared, they would have drawn up the financial statements in a way which would have disclosed them.

A similar view was expressed in an opinion concerning the Illinois Zinc Company where the inventory was overstated and the depreciation, depletion, and amortization charges were inadequate. In that opinion,[27] the Commission said:

> There is nothing to indicate that the accountants were aware of the practices in question at the time they certified the financial statements. So far as appears, they were the innocent dupes of designing corporate officials. This fact, however, cannot exonerate them of all blame in connection with the false and misleading financial statements. . . . Had they been completely alive to their functions as independent auditors, they would have discovered many of the improper practices and accounting improprieties. . . . The audit, as conducted, did not measure up to type of audit to which stockholders are entitled.

The greatest threat to the independence of the accountant lies in undue subservience to the wishes of the client because of the fear of losing the engagement. It is relatively easy to determine whether the accountant is an employee of the corporation, whether he is a substantial shareholder, or whether his employment is on a contingent fee basis. Except in the most flagrant cases, however, it is not easy to determine whether he has permitted his judgment to be affected because of pressure from the client. It is immaterial whether his attitude is manifested in a conscious misstatement of the facts or in his neglect to make an adequate investigation. The results are the same in either case, namely a misleading financial statement.

[26] SEC Release No. 1786. Aug. 5, 1938.

[27] Securities Act Release No. 2180. Feb. 20, 1940.

PROPOSALS FOR STRENGTHENING THE POSITION OF THE ACCOUNTANT

Most accountants realize that their greatest professional asset is their reputation for independence and that their usefulness would be impaired if not destroyed if the public should be led to believe that as a profession they are willing to yield to the influence of clients in drawing up and certifying financial statements.[28] However, it is believed by some persons that a minority of accountants have not met their full responsibility to their profession and to the public.[29] The reasons given are that accountants have traditionally been engaged by the management rather than directors and stockholders, that accounting as a profession is still competitive, and that accountants feel unqualified to criticize many items entering into the accounts, particularly inventory valuations, the amount of the charges for depreciation, and the valuations placed upon fixed assets by appraisal. The position of the accountant prior to 1933 was greatly strengthened by such organizations as the professional societies of accountants and the New York Stock Exchange. The influence of the Securities and Exchange Commission has also been very significant, for the accountant can now oppose unsound practices on the ground that they will not meet the approval of the Commission.

Demand for another important change has been increasing, namely, that the selection of the auditor should be entrusted to some one other than the management. The demand for this change received impetus from the disclosures in the McKesson and Robbins case in December, 1938, in which it was shown that checks set up for the control of the management are often subject to control by the management itself. One proposal is that the auditor should be named by the board of directors and should make his reports to the directors, the stockholders, the Securities and Exchange Commission, and the stock exchanges on which the securities of the company are traded. According to this plan, the reports should be not only addressed to directors and stockholders but also mailed individually to each one of them. The auditors should be present at meetings of stockholders and directors where their reports are presented and should answer any legitimate questions concerning them. If a change in the auditors is contemplated by the board of directors or the officers, notice should be given to the stockholders together with a statement of the reasons for making the change.[30] The accountants should also be elected at the beginning of the year with the right of access to the books at all times.

These changes in some cases would be significant, but in many other cases they would not make any difference because the president and other officers sit on the board of directors and dominate its decisions. As a further corrective it has been suggested that the auditors should be elected by those directors who are not also officers. In too many cases, however, the directors who are not officers give little or no time to the study of the affairs of the company, know little about its business, and do not care to assume any definite responsibility.[31] If the proposal to make the accountant responsible to the directors is to effect a significant change, there must be a change in the relation of the board of

[28] See "Independence of Auditors" (Editorial), *Journal of Accountancy*, Vol. 69: 249–251, April, 1940. Also "Relations with the SEC," *Journal of Accountancy*, Vol. 67: 2–3, July, 1938.

[29] See George C. Mathews (former member of SEC), Address before the Milwaukee Chapter of Wisconsin Society of Certified Public Accountants, Jan. 8, 1937. Also SEC Report on Investment Trusts and Investment Companies, Part 3, Chapter VI, p. 30 (1940).

[30] See *Testimony of Expert Witnesses before SEC in the Matter of McKesson and Robbins*, especially the testimony of Samuel J. Broad, p. 9, Washington, Sept., 1939.

[31] See address of William O. Douglas, former Chairman of the SEC, before Fort Worth Clearing House Association, Jan. 9, 1939.

directors itself to the corporation.

The proposal to have the accountant chosen by and made responsible to the stockholders has more to recommend it,[32] but this will also fail unless some system can be found to permit stockholders to take a more direct part in the affairs of their company. Stockholders' meetings of a large corporation are usually attended by few persons other than the management itself, and they are easily controlled through the use of proxies. In exceptional cases, however, this would be an important check upon the management and would serve to give the accountants greater independence. A few companies have amended their by-laws to permit the shareholders to name the auditor, among them Consolidated Edison Company and Radio Corporation of America.

Creditors of a company, whether bondholders or short-term creditors, have an important stake in the enterprise and an interest in the financial statements prepared by the auditor. While it has been urged that certain creditors should be entitled to a voice in the selection of the auditor, no one has suggested a feasible plan for bringing this about in any but the most exceptional cases.

A more far-reaching proposal is that the accountant who certifies the financial statements in connection with the issue of new securities and the statements of corporations whose shares are traded on a stock exchange should be selected by the Securities and Exchange Commission to function somewhat after the manner of national and state bank examiners. This proposal has not yet been strongly advocated and the plan has serious weaknesses on the administrative side, but it would certainly have the effect of making the auditor entirely independent of the management and representative of the interests of all persons related in any way to the corporation.

Another proposal, which was embodied in the first draft Wagner-Lea Bill for the regulation of investment companies, is that the Securities and Exchange Commision be authorized to prescribe the minimum scope of and procedures to be followed in any audit of a registered investment company. This bill, which was introduced in both houses of Congress in March, 1940, also provided that accountants or auditors must keep reports, work sheets, and other documents relating to the audit of such companies and that they must make these papers available for inspection by the Commission or its representatives. It also authorized the Commission to prescribe the accounts in which various transactions would be entered and the manner in which entries would be made.

This proposal was objected to by accountants, who contended that the minimum procedure would tend to become the maximum and that an audit of accounts and financial statements cannot be reduced to a mechanical procedure. It has been pointed out by a Committee of the American Institute of Accountants that no two audits can be made in exactly the same way and that the accountant must be trusted as a professional man to make whatever tests and checks appear to him to be necessary and to apply accounting principles to each individual situation.[33] However, the case of the professional accountant is clearly weakened by exposures of misleading if not fraudulent accounting practices and financial statements when such statements are certified by professional accountants. In one well-known

[32] Francis G. Allen, "Certified Auditors—for Whom?" *Barrons*, Vol. 18, p. 3. Dec. 26, 1936. Also "One Good Check," *Financial World*, Vol. 70, p. 12. Dec. 28, 1938.

[33] See statement by the Committee of which John K. Mathieson was Chairman, "The Investment Trust Bill and Accountancy," *Journal of Accountancy*, Vol. 69: 348–353, May, 1940.

case, an investment trust engaged two firms of accountants, one as auditors and one as consulting accountants, and it still was able to conceal very questionable accounting practices and to issue seriously misleading statements.[34] This was no doubt an exceptional case, but it is often just this sort of case that requires legislation to correct it.

In the final form, as enacted by Congress, the Investment Company Act of 1940[35] did not authorize the Commission to exercise detailed supervision over the work of the accountant, but it did provide that the financial statements of registered investment companies shall be signed or certified by an independent public accountant appointed by a majority of those members of the board of directors who are not investment advisers, officers, or employees of the company. The selection of the accountant must be submitted for ratification or rejection at the next succeeding annual meeting of the stockholders. The certificate or report of the accountant shall be addressed both to the board of directors of the company and to the security-holders. The Commission is authorized to require accountants and auditors to keep reports, worksheets, and other documents and papers relating to the companies audited and to make them available to the Commission for inspection. However, the Commission is not authorized to prescribe the procedures to be followed by the auditor or the form of his working papers. In the form in which it was finally enacted, the Investment Company Act does not place undue restrictions upon the professional work of the auditor.

It should be said that the vast majority of public accountants have always adhered to the highest professional standards. The agitation for a change in the relation of the accountant to his client has arisen because of the neglect of their duties and professional ethics by a small minority of practicing accountants. Without any further change than that effected by the Securities Act of 1933 and the Investment Company Act of 1940, it may be hoped that the influence of the Commission together with the work of professional societies and individual accountants will cause that small minority of accountants to observe the requirements imposed upon them by the ethics of their profession and by their obligations to investors, creditors, and the public.

SUGGESTIONS FOR THE CONTENT OF CORPORATE REPORTS

Alex Eisenstein

The past few years have given birth to a remarkably increased attention to the form and content of corporate reports to stockholders. Despite the interest in this area, very little research has been inaugurated to determine exactly what type of information stockholders desire. In a general way everyone knows that a stockholder wants the financial statements, i.e., balance sheet and profit-and-loss statement. Beyond this, however, is a vast unexplored, uncharted wilderness. The additional information contained in the annual reports has ranged from absolutely no additional information to reports

[34] SEC Report on Investment Trusts and Investment Companies, Part 3, Chapter VI (1940).

[35] Public No. 768, 76th Congress, Ch. 686, 3d Sess., adopted Aug. 22, 1940.

containing hundreds of pages of supplementary data. The annual reports of The Diamond Match Company, for example, range from 150 to 250 pages each year.

This research was undertaken with a dual objective. First, to determine what information the investor desired in an annual report of a corporation, and secondly, to formulate a "check-list" based upon the results of such a survey which might act as a guide to officers and directors in their yearly task of reporting to the stockholders.

Letters were sent to various persons, including faculty members of several universities, lawyers, accountants, businessmen, investors, college students, housewives, etc., requesting an answer to the following question:

> What information do you, as a private investor, want in the annual report of a corporation in order to help you make an intelligent decision about buying, holding or selling its securities?

Because of the activities of the Securities and Exchange Commission and the various Public-Service Commissions in enhancing the form and content of financial statements, it was suggested that all comments be directed towards those *nonaccounting* items which were desired in the annual report.

The replies were surprisingly complete; an indication, perhaps, of the current interest in the topic. All the opinions were tabulated. Additional suggestions were excerpted from recent literature. Some of the suggestions seemed rather startling and unorthodox. However, in order to ascertain whether some of the ideas were really revolutionary a comprehensive study was made of several hundred annual reports of listed companies issued during the past ten years. Pertinent excerpts were culled for every item in the proposed check-list. The results of this project indicated that almost every item included in the proposed guide had been disclosed or discussed, with varying degrees of completeness and adequacy, in one or another of the annual corporation reports, albeit no one report contained all of the desired information.

To be sure, the amount and kind of information doled out in the annual report must depend upon the nature of an industry and a specific company. The report of General Motors will naturally have to be substantially different from the report of The Pet Milk Company. However, if it be conceded that the information contained in the following proposed guide will not be onerous or harmful to a company then the burden of justifying any exclusions should rest upon the company. The fact that many companies have seen fit to divulge the data requested is prima facie evidence that such disclosures can be made in many cases without incurring any competitive hardships.

In the past few years there has been a formidable advance towards uniformity in the form and content of financial statements and, perhaps even more important, in the adoption of uniform principles and conventions of accounting within specific industries, e.g., uniform principles of inventory costing and valuation, depreciation, depletion and amortization policies, principles regarding charges to surplus, etc. Pressure for such uniformity has been stemming from powerful trade associations, the Securities and Exchange Commission, the Interstate Commerce Commission, and other Federal agencies. However, the nonaccounting elements of the annual report have received only scant and inadequate criticism. This was very effectively recognized by George C. Mathews in a speech dealing with information to be contained in SEC registration statements or prospectuses:

> Any general form which the Commission adopts will turn out in practice to be inadequate in particular cases. Material factors will fall in the interstices. Beyond this, there is an area of ma-

terial factors having influence upon the particular enterprise the ascertainment and understanding of which are beyond the capabilities of the average intelligent investor. For lack of a more apt description, these factors may generally be characterized as intangibles, although many of them are not intangibles but definitely existing facts in the totality of the enterprise which do not lend themselves to ready observation and precise measurement.

These intangibles are, nevertheless, the very factors which may influence most the ultimate investment value of a security. Were it not for the existence of these intangibles, the appraisal of security values could always be expressed with almost-mathematical accuracy and without the need of intelligent judgment on the part of the investor.

Mr. Matthews was, of course, referring to the information to be contained in the registration statements or in prospectuses. However, might it not be desirable to think of the annual reports of corporations as in the nature of continuing prospectuses?

Obviously, no amount of available recorded information can ever be a substitute for intelligence and sound judgment. Furthermore, it is quite probable that the individual private investor will never be in a position to automatically make really safe investments, regardless of the quantity and quality of data on hand. Anything which might tend to create such an impression is definitely misleading; and it is certainly not the object of this article to suggest that the annual corporate reports can be improved to the extent that safe channels for investment of funds could be selected quite mechanically. All that the annual reports can and should do for the stockholders is to present certain interesting, significant and material information in a readable style and format. Stockholders will labor under an unfortunate delusion if they assume that an annual report reveals safe avenues for future investment. After all, the annual report is usually issued about three to five months after the close of a fiscal year and is therefore reporting events which may have had their inception from fifteen to seventeen months earlier. And to a great extent the annual report must simply narrate past events and the results of past operations. Furthermore, it will always be practically impossible to evaluate the various human, personal factors which, in the last analysis, constitute the business organization.

Despite these limitations, there still appears to be ample justification for having these data on record. This survey revealed that most intelligent investors definitely desire information beyond the mere financial statements. Although many corporations have been presenting such additional information, the chief objection has been that the method of presentation is inconsistent, incomplete and unsystematic.

The following outline is an initial attempt to introduce some semblance of consistency and systematic presentation in corporate reports. A reasonable objection which was encountered when the original outline was being circulated for comment was that the inclusion of all the suggested data each year would make the annual report a bulky and expensive document, a waste of a substantial amount of stockholders' funds and an unnecessary burden upon some members of the organization. Wherever these objections would be valid it is suggested that the reports to stockholders be prepared in two sections. One section should contain the relatively permanent background and basic history of the company. Five major divisions would be used:

1) Corporate and Business History
2) Management
3) Labor Relations
4) Operations
5) Public Relations.

The following check-list is recommended as a guide in preparing the master-report.

I. *Corporate and Business History*

1) Date and state of incorporation

2) Duration of the company's charter
3) Names of the individuals who established the company
4) Amount of capital contributed by each original investor
5) Description of the original plant and type of business conducted
6) Principal additions to plant and years in which constructed
7) Outline of changes in productive capacity from year to year
8) Diversification of products during past years:
   a) Unprofitable items which were abandoned
   b) New products which were developed
9) Changes in the subsidiary structure:
   a) Names of new subsidiaries and year of acquisition
   b) Capitalization—also per cent of stock held by company
   c) Purposes of acquisition
   d) How acquisitions were financed
   e) Relations with parent company
   f) Old subsidiaries which were dissolved
   g) Reasons for such dissolutions
10) Changes in the capital structure:
   a) New securities issued—amount, dates and purposes
   b) Securities retired—amounts, dates and reasons
   c) Refundings, revaluations, split-ups, etc.
   d) Dividend history, including stock dividends

II. *Management*

1) Name of each executive, plus:
   a) Age
   b) Number of years in the industry
   c) Number of years with the corporation
   d) Number of years in present official capacity
   e) Family relationships by blood or marriage that exist in the executive group
   f) Compensation, including all forms of remuneration
   g) Ownership of stock in the company
2) Name of each member of the Board of Directors, plus:
   a) Age
   b) Occupation
   c) Other business affiliations, especially with the company's financial backers, principal customers or suppliers
   d) Relationships, family and otherwise, with principal executives
   e) Ownership of stock in the company
3) An organization chart setting forth lines of authority and duties of each principal executive
4) Details of the training program for younger executives, i.e., are the younger men being taught to assume increased responsibilities or are there "indispensable" men in key positions?
5) Details of executive profit-sharing or bonus plans

III. *Labor Relations*

1) A complete record of past labor difficulties
2) Degree of unionization at each plant
3) A summary of relations with organized labor
4) Number of employees for each of the past ten years
5) Total payroll for each of the past ten years, with a breakdown by executives, plants, office and sales
6) Details of all employee profit-sharing or bonus plans
7) Details of other contributions to employee clubs, pension schemes, etc.

IV. *Operations*

1) List of major products and services
2) Sources of raw materials used by the company
3) Physical plant and properties, including:
   a) locations of plants and proximity to,
      1. sources of raw materials
      2. fuel, water, power, labor
      3. markets for finished products
      4. economical transportation
   b) description of buildings at each plant showing age and type of construction
   c) capacity of each plant
   d) rate of operations during the past ten years
   e) map or photograph of each plant
   f) clear statements of depreciation, depletion and obsolescence policies accompanied by detailed statements
4) A list of principal patents owned or leased and the expiration date of each
5) A summary of the company's research program, including:
   a) new products developed
   b) new processes developed
   c) old products and obsolete processes discarded
6) A review of the company's advertising operations

7) A digest of the company's marketing methods, including:
   a) scope of the selling territory
   b) amount of foreign business
   c) significant changes in methods of distribution, territories or customers during the past five years

V. *Public Relations*
1) A digest of past public relations programs and principles
2) Membership in trade associations and other organizations, including:
   a) Name of the association
   b) Purposes of the association
   c) Financial contributions made by the company
   d) Other companies included in the association
   e) Directors and officers of the association
   f) Accomplishments of the association

This master report should be revised about once every five years. It should be sent out to all present stockholders on record and to each new stockholder at the time his name is recorded in the Stockholders' Ledger. Such a report would be both a valuable historical document for stockholders and a reservoir of information for new officers and executives as well as for old-timers who are too prone to rely upon an "infallible" memory. Its value to analysts, potential investors, creditors, bankers, etc. etc., would be vast and immeasurable.

With this basic information available in the hands of each stockholder, the annual reports would be in the form of supplements, bringing the story up-to-date, reporting the more current and timely information, indicating significant changes in policy and administration, presenting current financial statements, etc.

The essential information to be contained in the annual supplemental reports would follow the broad outlines of the master report. The following current data would be submitted in addition to the various financial statements:

III. *Labor Relations*
1) Labor turnover for the past year.
2) Average number of full working days for each employee during the year.
3) Age distribution of the employees.
4) Starting wages, standard hours of work, and average wages and hours.
5) An abstract of the program of the Personnel Division.
6) A summary of any pending labor disputes.
7) Any orders against the company issued during the year by the National Labor Relations Board or other governmental agency.
8) A statement from the local union officials of the relationship between the company and its employees and between employees and the union.
9) A statement of relations between employees, first-line supervision and higher company officials.

IV. *Operations*
1) An outline of important additions to plant facilities during the year.
2) Summary of appropriations for capital expenditures in the future.
3) Summary of any patent litigation during the previous year.
4) Summary of important contracts with producing or distributing agencies not owned by the company.
5) A statement of the corporation's relative position in the industry.
6) Major distributing methods, including a summary of relationships and contracts with major distributing organizations.
7) A list of the larger customers and the percentage of total sales made to them.

V. *Public Relations*
1) Government suits or investigations pending or in process.
2) A digest of the public-relations program.
3) Measures taken for cooperation with the government in the solution of basic social and economic problems.
4) A candid statement of unfavorable situations confronting the industry and the company, including:
   a) taxation
   b) burdensome legislation
   c) trends in regulation and control of operations by government bodies.

d) transportation difficulties
e) foreign markets and investments
f) general business conditions and trends in the industry.

5) Steps taken to improve relations with the public, labor and stockholders.

It should be again emphasized that the foregoing check-list is simply proposed as an aid in the preparation of reports. Numerous changes will be required to make the outline suitable for any particular enterprise. A substantial amount of the data can be presented in tabular form. Other items will simply require one or two sentences. In most cases, the report which will result from following the suggested outline will be very interesting, complete and useful. After all, it must be presumed that those people who have invested their money in the stock of a company are vitally interested and perhaps legally entitled to fairly complete information on the results of management's stewardship of their funds, especially when one realizes how widespread ownership really has become. Only six of the larger corporations, for example, have almost 2,000,000 stockholders[1] and it is estimated that about 10,000,000 persons are stockholders in this country, with average holdings of less than 100 shares.

Analysis of Treasury Department figures for 1938 reveals that less than one per cent of the corporations (394 companies) made 42.3% of the total corporate profits in that year.[2] Surely, some serious obligation to render complete reports must be attached to this huge concentration of power; and it appears that an obligation is not only owed to stockholders, but in a broader sense, to employees, customers, creditors and the public at large. The increasing recognition of the quasi-public nature of most large companies is bound to result in accelerated pressure for more methodical scrutiny of their methods of operation and their relationships with stockholders, employees, creditors, consumers and the general public.

> For democracy can stand firm only if all the facts of its economy are known to the people. Under a truly representative form of government, the choice of the road that we are to travel lies in their hands and they can shoose wisely only if all the facts are known.
>
> At first necessity today is for industrial management to recognize this and to endeavor, through every possible channel, to take the mystery out of business operations.
>
> Each individual company has an affirmative and constructive story to tell of its social and economic contributions.[3]

Unless this movement is soon comprehended and constructive action is taken to meet these responsibilities, it is quite possible that American business will be saddled with a new type of regulation—regulation of the way in which reports of management and its stewardship are to be prepared. The implications of this thought are far too broad to be further explored in the present article. However, it seems obvious that a voluntary raising of the standards of annual reports, whether on a purely individual company basis, or through concerted trade-association or industry-wide efforts, would be far more palatable than government intervention.

[1] Amer. Tel. & Tel. . . . 636,771; Gen'l Motors . . . 388,650; Pa. R.R. . . . 209,346; U.S. Steel Corp. . . . 216,706; Gen'l Elec. Co. . . . 210,919; R.C.A. . . . 244,105.

[2] Treasury Department Release No. 23-85. March 12, 1941, p. 14.

[3] "Making the Annual Report Speak for Industry," Selvage, J. P., and Lee, M. M., McGraw-Hill, N. Y., 1938. Compiled for the National Association of Manufacturers.

OVERCAPITALIZATION HAS LITTLE MEANING

T. LEROY MARTIN

THERE has been a great deal of loose thinking and writing by economists in regard to the concept of overcapitalization as applied to corporations. It is proposed in this paper to present for critical analysis currently accepted definitions of overcapitalization, to point out the fallacies upon which they are based, and to consider the possibilities of formulating a definition not subject to these criticisms.

Overcapitalization was defined in a senate bill[1] introduced in 1911 by Senator Newlands of Nevada as follows:

> The commission . . . may revoke the registration of any such corporation upon the ground of overcapitalization; that is to say upon the ground that the par value of the total securities, including shares of stock and all obligations running for a term of—years or more, of such corporations, issued and outstanding at any time clearly exceeds the true value of the property of the corporation at that time. In determining such true value the said commission shall consider the original cost of such property, its present replacement cost, its present market value, including the goodwill of the corporation's business and the fair value of the services rendered in the organization of such corporation.

The difficulty in dealing with this definition is the vagueness of the term, "true value." One presumes that it may be logically assumed that revaluation is to be made upon grounds purporting to be economically unsound. Each factor to be considered in determining true value, with the exception of original cost, fluctuates with the price level, while the par value with which it is to be compared is rigidly fixed. It them becomes apparent that, according to the above definition, a corporation may become overcapitalized by a change in price level. If a change in price level actually makes a corporation's capital structure economically unsound, the definition cannot be said to be invalid under a condition of changed price level.

CURRENTLY ACCEPTED DEFINITION

Professor Edward Sherwood Mead, referring to the definition set forth in the senate bill quoted above, says:[2]

> This definition is that currently accepted. If the face or par value of the shares of stock and the bonds issued by a corporation exceed the fair value of its property including goodwill, patents, franchises, and other forms of intangible wealth, that corporation is said to be overcapitalized.

Professor Avard Longley Bishop has defined overcapitalization as follows:[3]

> Those who have thought it worth while to consider them (proper capitalization, undercapitalization and overcapitalization terms) at all are generally well agreed that a concern is capitalized properly, as to its amount, when its securities sell in the market, in the long run, not far from their par value. Again an enterprise might be considered to be undercapitalized if its securities sold, over a considerable period of time, well above par; whereas an organization might be adjudged as overcapitalized if its securities continued to sell, for a fairly long period of time, considerably under par.

If we accept this standard of capitalization, the use of the terms "over" and "under" implies that a company is properly capitalized only when the par value of its securities outstanding is equivalent to their market value, qualified of course, by the phrase "over a long period of time."

[1] Senate Bill 2941, Section 10, Introduced July 5, 1911.

[2] Mead, Edward Sherwood, *Corporation Finance* (New York, 1931), Sixth Edition, pp. 222, 223.

[3] Bishop, Avard Longley, *The Financing of Business Enterprises* (New York, 1929), p. 153.

To anyone who glances even occasionally at the financial page, market value of the capital stock and bonds must seem to be a rather shifting and unreliable measure of overcapitalization and undercapitalization.

Professor M. G. Glaeser, author of an article entitled "Capitalization" in the *Encyclopaedia of the Social Sciences*, writes as follows:

> One of these problems concerns the relation of capitalization to the actual cost of assets and to present and prospective income. Were the assumptions of orthodox economic theory fulfilled and the cost of the productive assets equal to the capitalized value of their income yield, no important practical issue would center about this question. In that case it would not be difficult to make the par value of the outstanding securities equal to the actual cost of the properties of the concern. However, since perfect competition and free mobility of resources are rarely found in economic practice, the nice balance between capitalization and cost, and capitalization and capitalized income yield is seldom realized. The discrepancies give rise to problems of overcapitalization and undercapitalization, of which only the former, for obvious reasons, is likely to be of frequent occurrence and practical interest.[4]

If the authors of the quotations selected above had merely chosen the terms overcapitalization and undercapitalization to denote the result of certain numerical comparisons, their right to define any term as they please might be granted. But when they infer that an economically unsound condition exists, as the contexts of the articles and the excerpts do,[5] one has a right to question the use of the terms to describe the conditions therein set forth.

The fundamental question to be answered in dealing with this subject is: What value is the proper one to use for judging the economic soundness of a corporation?

A paragraph by Charles W. Gerstenberg throws further light upon the fact that overcapitalization and undercapitalization do not mean the same thing to different economists:

> Industrial and mercantile concerns should capitalize on a basis of earning power. The most convincing argument it seems to us, to justify this basis of capitalization, is that it recognizes the fundamental truth that a business is a profit making entity and that it is worth what it will earn. If stock is issued to an amount in excess of the capitalized actual earning power of the company, the company is said to be overcapitalized and the stock is said to be watered.[6]

Mr. Gerstenberg's explanation of overcapitalization has a somewhat different basis than those previously discussed except perhaps Professor Gleaser's definition. Bonds are excluded from consideration. Mr. Gerstenberg measures overcapitalization by the ability of a business to earn a current rate of interest upon the par value of capital stock. Professor Glaesser refers to capitalized income in relation to cost of the assets. Mr. Gerstenberg refers to the relation of capitalized income to the par value of capital stock.

There is a fundamental distinction between the definition of overcapitalization given in Senate Bill 2941 and Mr. Gerstenberg's definition. The first compares the fair value of the property of the corporation with the par value of its capital stock and funded debt. The latter compares actual earnings capitalized at the current rate of interest with the par value of the capital stock. Judged by the latter criterion, a corporation might have little valuable tangible property as compared to the total par value of its capital stock and yet not be overcapitalized so long as its earning power is great enough. The lack of tangible assets may be counterbalanced by the presence of an intangible goodwill. Mr.

[4] Encyclopaedia of the Social Sciences (New York, 1931), Vol. III, pp. 208–211.

[5] See for example, *ibid.*, p. 209, "... the charge of overcapitalization has been leveled principally against public service corporations."

[6] Gerstenberg, Charles W., *Financial Organization and Management* (New York, 1934), p. 307.

Gerstenberg's remarks in regard to undercapitalization and goodwill are particularly interesting:

> The disadvantages of overcapitalization are greater than those of undercapitalization, if for no other reason than that the undercapitalization may easily be remedied by writing the intangible asset "goodwill" into the balance sheet and distributing the resulting surplus through a stock dividend. A company that is undercapitalized ought always to follow this practice, for its stock ordinarily will not sell at its full value.

One is immediately made to wonder if overcapitalization as here defined could not just as easily be reducing the par value of the stock or by reducing proportionately the number of shares. A stockholder gains no value from a stock dividend and loses no value by a proportionate reduction in capital stock. Aside from the mere mechanical ease of accomplishment, a reduction of capital stock or of par value, if it were considered desirable, would have the benefit of legal sanction. On the other hand, the process of writing goodwill into the accounts and declaring even a stock dividend from the surplus thus created would be found to be illegal in many states.[7] Moreover, it is a generally accepted accounting principle that "... goodwill should be recognized as an asset only when actually purchased on a cash or equivalent basis."[8]

Another author, Mr. Floyd Burtchett, says:[9]

> Financial structures prepared in periods of prosperity and under conditions of speculative market psychology are easy to overcapitalize; that is, it is easy to sell securities, the par or stated value of which is in excess of the current value of the assets.

This explanation of overcapitalization is so vague that one is tempted to disregard it. If the writer means that it is easy to sell new stock of the same type as that already outstanding when the par value of the stock already outstanding is in excess of the current value of the assets, it should be pointed out that selling the new stock may not increase but, on the contrary, may even reduce the overcapitalization. Every new share sold at a price in excess of the current value (net current value of assets divided by the number of shares outstanding) reduces this so-called overcapitalization. It is reduced because the sale of stock requires the payment of cash equal to the sales price; and, since the old and new shares are alike, as water seeks its own level, each share becomes worth the same amount, a value higher than that of the old shares. The value is higher because the excess paid above the current value is shared by old and new shares alike.

If Mr. Burtchett means that new shares are to be sold at par value, no so-called overcapitalization can be created, although if it existed before, it may still exist to a lesser extent. And if he means that new stock is to be sold below par, overcapitalization may yet be lessened if the sales price is above current value. It must be observed that the worse the market condition is, the more likely it is that overcapitalization, as here defined, will occur—not the contrary as the quotation suggests.

Regardless of the vagueness of the explanation of the process of overcapitalizing, the above description seems to define overcapitalization itself as the excess of par or stated value over the current value of the assets.

COMPARISONS OF DEFINITIONS

There are three distinct variations in the definitions of overcapitalization examined above. The three types of definitions stated in abbreviated form are that overcapitalization exists when:

---

[7] See Yang, J. M., *Goodwill and Other Intangibles* (New York, 1927).
[8] Paton, W. A., *Accounting* (New York, 1938), p. 267.
[9] Burtchett, Floyd, *Corporation Finance* (New York, 1934), p. 366.

1. Par value of the securities exceeds the fair value of assets including intangibles;
2. Par value of the capital stock exceeds the market value of the stock;
3. Par value of the securities exceeds the capitalized income yield of the business.

These definitions will be examined in turn in the following paragraphs.

EXAMINATION OF FIRST TYPE OF DEFINITION

The first type of definition, which states that overcapitalization exists when the par value of the stock exceeds the fair value of the assets of the corporation, at first appearances seems to have the fundamental weakness of comparing an absolutely fixed amount, par value, with an uncertain amount, fair value. Maintaining that two such dissimilar values ought to remain equal in order that a corporation be in the most economically desirable position appears on its face to be untenable.

Following is a list of some of the circumstances which are to be examined in order to determine their effect upon the corporation and also their effect upon the application of this definition:

1. A general fall in commodity prices, which produces a decrease in replacement cost of assets;
2. Operation at a loss;
3. Failure to provide for certain charges against earnings, such as sufficient depreciation or obsolescence, and the simultaneous payment of dividends in excess of true earnings;
4. Overvaluation of property for which capital stock is issued in payment.

The above conditions are only a few of those under which the application of the definition of overcapitalization might be examined. A decrease in the replacement cost of certain assets is chosen to represent a condition which cannot be avoided in business operation. Increases in replacement cost are not considered here since the comparisons of resulting values would indicate the opposite of the condition measured by this type of definition.

It is well known that during any selected period many businesses are operating at a loss, and that the majority of them suffer losses at some time or other; for that reason it is necessary to test the definition of overcapitalization under the above condition. Moreover, operation at a loss is one of the essential criteria of the absence of economic soundness as defined below.

The definition is to be studied under the conditions of erroneous accounting procedure, such as the failure to provide adequately for depreciation, because it is a well-known fact that accounting procedure varies in this respect. It is therefore maintained that a tenable definitive measure of an economically unsound condition must react as far as possible independently of purely bookkeeping concepts of earning capacity.

Actual overvaluation of property for which capital stock is issued is selected as one of the conditions under which the definition is observed because overvaluation of property is the circumstance most commonly referred to as overcapitalization. It is beneficial here since, being a condition generally recognized as undesirable, it furnishes an opportunity to regard the result of the application of the definition under conditions admitted to be undesirable.

It is not claimed that these conditions are the only ones under which it might be desirable to observe the results of the application of this definition. The choosing of these particular conditions is believed to be justified in that one or more of them is unavoidable in operating a business enterprise in the present-day economic world. There may be other unavoidable conditions which are worthy of study but they

will not be discussed because their support is not necessary to demonstrate the weaknesses of the definition. The failure of the definition to register an undesirable situation under any one of the conditions stated here is sufficient grounds for its rejection as a general definition of overcapitalization.

THE FAIR-VALUE CONCEPT

In *Smyth v. Ames,* decided in 1898, the United States Supreme Court established the principle that railroads (the principle has since applied to other public utilities) are entitled to a fair return upon the fair value of their property. The courts have not, however, in all the years since then satisfactorily defined the term "fair value." In the decision of *Smyth v. Ames* the Court enumerated a number of factors to be considered as the criteria of fair value. The following quotation from the case lists those factors:

> The basis of all calculations as to the reasonableness of rates to be charged by a corporation maintaining a highway under legislative sanction must be the fair value of the property being used by it for the convenience of the public. And in order to ascertain that value, the original cost of construction, the amount and market value of its bonds and stock, the present as compared with the original cost of construction, the probable earning capacity of the property under particular rates prescribed by statute, and the sum required to meet operating expenses, are all matters for consideration, and are to be given such weight as may be just and right in each case. We do not say that there may not be other matters to be regarded in estimating the value of the property. What the company is entitled to ask is a fair return upon the value of that which it employs for the public convenience.[10]

It is unnecessary to present proof of the fact that regulatory bodies have given varied weights to the factors listed above in fixing rate bases for public utilities. Every textbook on public utilities, regulation of public utilities, or transportation presents evidence that no specific rules have been applied.

Consideration of the concept of fair value is forced into the examination of the definition of the first type, and for the purposes of this examination the amounts used as the fair value of the enterprise must be assumed. No attempt is made here to define fair value. The amount chosen by regulatory bodies to represent fair value will be used in the following illustrations.

The terms overcapitalization and undercapitalization as currently used imply conditions of unsoundness—and if the words are to have any meaning at all it should be one which signifies an unsound condition. In order to study the possibilities of formulating some test which will measure unsoundness and perhaps over- and undercapitalization, let us make clear the meanings of some of the terms.

In the discussion which follows, economic soundness refers only to soundness in relation to the amount of capital and earnings. The fact that a corporation might have a better balanced proportion of common and preferred capital stock or of bonds and capital stock are factors which may be disregarded in the indictment of the definitions. Based upon other criteria of economic soundness, these definitions must necessarily prove to be invalid for the simple reason that they are numerical comparisons which disregard all factors except the amount of capital, earnings and asset values.

The term economic soundness as here used will mean the ability of the corporation to earn a fair return on capital. Economic soundness is used here in the very narrow sense of soundness of the business itself. A broad meaning of economic soundness would, of course, include the factor of soundness in relation to the industry in question and to the whole economy. There may be a better title for the condition of economic soundness, but the writer has

[10] 169 U. S. 466, 546–547.

been unable to evolve a more suitable descriptive title.

The term capital as used here includes capital stock and surplus of whatever nature. Fair return will mean not necessarily a specific rate but a return in terms of "real" income sufficient to maintain the amount of capital considered economically necessary to the industry of which the corporation is a member. Rate of return is advisedly omitted because of the effect of changes in price level upon it.

I. In the discussion of the effect of a general decrease in commodity prices upon the application of a definition of the first type, let it be assumed that The Prime Corporation presented the following condensed balance sheet:

THE PRIME CORPORATION
Balance Sheet, December 31, 1940

Assets	
Current Assets	$100,000
Fixed Assets (less depreciation)	700,000
Total Assets	$800,000
Liabilities and Capital	
Current Liabilities	$ 75,000
Fixed Liabilities	100,000
Preferred Capital Stock (par value, $100)	200,000
Common Capital Stock (par value, $100)	300,000
Earned Surplus	125,000
Total Liabilities and Capital	$800,000

Let it be assumed that two years after the preparation of the above balance sheet commodity prices in general dropped. The changes in prices referred to here are long-run or secular changes. The current items which are continually being converted are assumed to be recorded at values consistent with their current prices. The fixed items are stated in dollar value of the previous era of higher prices. Fixed liabilities are stated at $100,000, a value which does not change with price levels. It is the item of fixed assets which may be affected by the decreased price level.

Let it be assumed that an appraisal by engineers placed the reproduction cost new less estimated depreciation of the fixed assets at $500,000. The balance sheet of The Prime Corporation as it might appear two years after the date of the first balance sheet is as follows:

THE PRIME CORPORATION
Balance Sheet, December 31, 1942

Assets	
Current Assets	$180,000
Fixed Assets (less depreciation)	670,000
Total Assets	$850,000
Liabilities and Capital	
Current Liabilities	$ 60,000
Fixed Liabilities (5% bonds)	100,000
Preferred Capital Stock (par value, $100)	200,000
Common Capital Stock (par value, $100)	300,000
Earned Surplus	190,000
Total Liabilities and Capital	$850,000

A regulatory body, after consideration of all pertinent information concerning fixed-asset values, might set the fixed-asset value of The Prime Corporation at $470,000. It may be assumed that the regulatory body duly considered the original cost of the fixed assets of $700,000, the replacement cost less estimated depreciation of $500,000, the market value of the stocks and bonds of the corporation, and the probable future earning power of the corporation and that they arrived at the figure of $470,000 after weighing these values according to their concept of the merits of the case. If current items are included in the total estimate at their book value, a total fair value of $590,000 might be arrived at as follows:

Fair Value of Fixed Assets	$470,000
Add-Book Value of Current Assets	180,000
Total	$650,000
Less-Current Liabilities	60,000
Total Fair Value	$590,000

According to the definition, the difference between the total par value of capital stock and bonds ($600,000) and the estimated fair value ($590,000) is the amount of overcapitalization. The corporation by this definition would be declared to be overcapitalized to the extent of $10,000.

At this point let it be assumed that the cost-of-living index is, say, twenty-five per cent lower than it was two years earlier. Since dividends on preferred stock and interest on bonds are computed as a fixed percentage upon a fixed par value, the preferred stockholders and the bondholders will be in a better "real" income position than they were two years earlier. The common stockholders, because of a greater proportion of net operating profit (if profits are smaller in dollar value) being paid to bondholders and a greater proportion of net earnings being paid to preferred stockholders, will probably be paid dividends in in terms of "real" income somewhat smaller than in previous periods. The dividends will be smaller unless recorded net earnings are lower than those of the previous period of higher prices by a smaller proportion than that by which the cost of living has fallen. The cost of living referred to here means that applicable to the station in life of the majority of the investors.

To make these points clear, let it be assumed that in the second year prices have acted in such a way that they have made the net operating profit twenty per cent smaller than it was in the previous year. (The rate of twenty per cent is assumed in order to demonstrate that the common stockholders may receive even proportionately more income in relation to the cost of living.) A general decrease in commodity prices may increase or decrease the net profit of a business unit. Price changes affect many things besides dollar values: a considerable change in volume of sales or even in the amount of labor required may be the result of changes in price. Assuming that the net operating profit before deduction of bond interest was $53,000 in 1940, the schedule below shows the earnings of common stock.

1940

Net Operating Profit before Bond Interest..	$53,000
Bond Interest, $100,000 at 5%...........	5,000
Net Earnings..........................	$48,000
Preferred Stock Dividends, $200,000 at 6%..	12,000
Balance = 12% Earnings on Common Stock of $300,000..........................	$36,000

If net operating profit before bond interest in 1942 were $42,400, that is, 20 per cent lower, the schedule shows 8.46 per cent earned on common stock, computed as follows:

1942

Net Operating Profit before Bond Interest..	$42,400
Bond Interest, $100,000 at 5%...........	5,000
Net Earnings..........................	$37,400
Preferred Stock Dividends, $200,000 at 6%..	12,000
Balance = 8.46% Earnings on Common Stock of $300,000..........................	$25,000

Investors as a group are approximately as well off as they were two years earlier, although their relative positions have been slightly disturbed. This statement is not to be interpreted to mean that the investor in actual life may not be financially worse off or even financially better off when cost of living and prices of commodities in general recede. The purpose here is to place the investors in approximately equal income positions under present and former conditions in order to examine the definition under conditions which by hypothesis have not been made appreciably less desirable by the changed price level.

After reading the above analysis one can hardly say that the corporation is in need of capital reorganization because of inability to pay interest or dividends. As a matter of fact, under present earning conditions, its surplus account would allow the payment of dividends in excess of earnings, for example, at a rate of ten per cent on common stock for approximately fourteen years before the surplus account would be reduced to the $125,000 balance existing at the date of the first balance sheet. The ability of the corporation to pay such dividends is shown by the following computation:

$4,600 excess over earnings = total of 10% on common stock.
$190,000 − $125,000 = $65,000, excess of surplus, 1942 over 1940.
$65,000 ÷ $4,600 = 14 years.

As proof that the test applied in the definition measures no unsound condition, it is assumed that The Prime Corporation, with proper approval by stockholders and by the state, reduces the par value of its 2,000 shares of common stock on December 31, 1942 to $95 a share and records the adjustment by the following journal entry:

Dr: Common Capital Stock	$10,000	
Cr: Capital Surplus		$10,000

The above entry is merely a book entry and in no way affects the intrinsic value of the stock to the investor. Each share of common capital stock still represents 1/2000 of the common stock equity, which total equity is in no way changed. The soundness of the financial condition cannot be directly changed by a mere book entry which effects a transfer of value from common capital stock to capital surplus. However, when the application of the definition of overcapitalization is made to the new capital arrangement, one finds that overcapitalization has apparently been corrected. The net asset fair value is $590,000. Par value capital for comparison is now:

Fixed Liabilities	$100,000
Preferred Capital Stock	200,000
Common Capital Stock	290,000
Total Par Value	$590,000

Total par value is just equal to fair value of the assets, and overcapitalization no longer exists. If overcapitalizaton as defined here is an economically unsound condition, a mere book entry has corrected it! The absurdity of eliminating an unsound financial condition by a bookkeeper's entry is apparent.

The conclusion must be that the first definition of overcapitalization is not tenable under a condition of a general decrease in commodity prices.

II. The next circumstance to be observed is operation at a loss. Beginning with the balance sheet of The Prime Corporation a of December 31, 1940, it is assumed that the company operated at a loss during the two succeeding years. All other things, including commodity prices in general, are to remain the same, the conditions bringing about unprofitable operation being considered to be inherent within the industry or individual company. It is also assumed that the replacement cost of fixed assets remains at the same level as that at the earlier time when the purchases were made.

At the end of two very unprofitable years, the balance sheet might appear as follows:

THE PRIME CORPORATION
Balance Sheet, December 31, 1942

Assets	
Current Assets	$120,000
Fixed Assets (depreciated value)	450,000
Total Assets	$570,000
Liabilities and Capital	
Current Liabilities	$ 85,000
Fixed Liabilities	100,000
Preferred Capital Stock (par value, $100)	200,000
Common Capital Stock (par value, $100)	300,000
Deficit (deduct)	*115,000*
Total Liabilities and Capital	$570,000

Assuming prudent investment in assets which have been replaced during the period, the fair value of the net assets might be fixed near the book value of $485,000, since by hypothesis replacement cost is unchanged. The actual process of valuation is assumed to be similar to that described in the discussion of the first condition. According to the definition under consideration, the corporation would be declared to be overcapitalized to the extent of $115,000, computed as follows:

Par Value of Bonds		$100,000
Par Value of Preferred Stock		200,000
Par Value of Common Stock		300,000
Total Par Value		$600,000
Fair Value of Assets	$570,000	
Less Liabilities	85,000	485,000
Overcapitalization		$115,000

The definition of overcapitalization when applied to the circumstance of operation at a loss seems to have fulfilled the function of designating an economically unsound condition. Whether this apparent proper functioning of the definition is an accident, or whether it is a true test of an unsound condition remains to be seen.

In the two-year period of operation, The Prime Corporation reduced its $125,000 surplus to a $115,000 deficit, a loss of $240,000. If the assumption should be changed so that the Corporation's balance sheet on December 31, 1940, contained an earned surplus item of $250,000 instead of $125,000, the same $240,000 loss during the two years would have reduced earned surplus to $10,000, instead of creating a deficit. Current assets would, therefore, be greater by $125,000 on December 31, 1942, than they were on December 31, 1941, if all items except current assets and surplus are assumed to be the same as in the balance sheet presented on December 31, 1942. Under the conditions postulated, the fair value of the net assets ought to be approximately equal to their book value of $610,000.

If it is assumed that the same authority would define the antithetical condition (fair value of the net assets exceeds par value of securities) as undercapitalization, which definition is demanded by consistency, the invalidity of this type of definition is more easily established.

The test applied by the definition under the changed condition regarding surplus finds not overcapitalization but undercapitalization of $10,000. This amount is the total par value of $600,000 minus $610,000, that is, a negative amount of $10,000.

Let it be assumed that, disregarding the advisability of such action, The Prime Corporation at this point paid a cash dividend of $10,000, amounting to $3\frac{1}{3}\%$ on common stock. The following journal entry records the net effect of the payment.

Dr: Earned Surplus..............	$10,000	
Cr: Cash (current assets).......		$10,000

By the dividend payment, fair value of net assets is reduced to $600,000, an amount just equal to the par value of the securities. Proper capitalization has been reached, that is, undercapitalization has been eliminated by paying out cash to the stockholders. It doesn't burden the imagination greatly to envisage a condition in which the paying out of $10,000 in cash might place the corporation in an unsound financial condition rather than correct such a condition. Instead of paying a cash dividend then, the corporation might issue a stock dividend of $3\frac{1}{3}\%$ upon common capital stock. Such a dividend might be recorded by the following entry:

Dr: Earned Surplus..............	$10,000	
Cr: Common Capital Stock.....		$10,000

Instead of decreasing assets so that total fair value equals par value of securities, the payment of a stock dividend increases par value to equal fair value. After the above entry, fair value and par value are both $610,000.

It must be observed here that the issuing of a stock dividend does not change the stockholders' equities in the corporation. Before the stock dividend was paid, the holder of thirty shares had a 30/3000 or a 1/1000 interest in the net worth attributable to common stock. Assuming that the preferred stock is neither cumulative nor participating, the above stockholder had a 1/100 interest in $10,000 of earned surplus before the stock dividend was issued. This is a total interest of $3,100. The holder of thirty shares would receive one share ($3\frac{1}{3}\%$ of thirty shares) as a stock dividend. Total common stock outstanding would then be 3,100 shares. There would be no balance of earned surplus. The holder of thirty shares would then have a 31/3100 or a 1/100 interest in common capital stock of $310,000, an equity of $3,100, the

same as he had before the stock dividend was issued.

The preceding analysis forms the basis of a conclusion that an adjustment which does not affect the equities of stockholders or creditors of a corporation can hardly correct or alleviate any unsound financial condition.

The second group of hypothetical values indicates that the definition does not register the existence of an economically unsound condition even after two years of operation at a loss. Application of the definition to the conditions of a corporation operating at a loss, while other factors remain fixed, indicates that overcapitalization is detected by the definition only when a deficit is created. The test by this definition detects unsoundness only when originally invested legal capital becomes impaired. Although an equal amount of capital accumulated from earnings would be wasted in losses, this test would still indicate undercapitalization.

It must also be pointed out that even if operation at a loss were coexistent with a rapidly increasing cost of replacement of fixed assets used in the industry, the fair value might be increasing at a rate sufficient to offset the effect of an increasing book deficit, and the test of the definition would register no overcapitalization even when a deficit was growing.

The first type of definition is rejected as untenable under the conditions of operating at a loss, since it has been shown that if other factors exerted enough pressure the definition would not indicate so-called overcapitalization.

III. The third group of conditions under which the first type of definition is to be studied is that of failure to make proper provisions in the accounts for depreciation or obsolescence, and that of simultaneously paying dividends to an extent which impairs capital without the record's indicating the impairment.

Beginning once more with The Prime Corporation's balance sheet as of December 31, 1940, it is assumed that the accounts shown therein are to be adjusted to give affect to changes in the book value of fixed assets, pursuant to a complete analysis and appraisal at cost of replacement which finds obsolescence and excessive depreciation existing but unrecorded. It is assumed that, after such adjustments have been made, the balance sheet appears as follows:

THE PRIME CORPORATION
Balance Sheet, December 31, 1940
Assets

Current Assets	$300,000
Fixed Assets (depreciated value after adjustment)	350,000
Total Assets	$650,000
Liabilities and Capital	
Current Liabilities	$ 75,000
Fixed Liabilities	100,000
Preferred Capital Stock (par value, $100)	200,000
Common Capital Stock (par value, $100)	300,000
Deficit (deduct)	*25,000*
	$650,000

If all other conditions remain fixed, and if the same valuation procedure is used as was followed in the first condition, fair value should approximate the book value of net assets, which is $575,000. Overcapitalization of $25,000 is indicated. This so-called overcapitalization is the result of the payment of dividends which should not have been paid. The company may have been operating at a fair profit, but because of miscalculations in estimating depreciation and obsolescence, was led to an impairment of capital through the payment of excessive dividends. The test by this definition reveals a condition which should not exist, since it is the result of illegal action—the payment of dividends so as to impair capital. But the corporation is not economically unsound; it is producing a fair return on the stock outstanding.

The reproduction cost of fixed assets of the type owned by The Prime Corporation

may increase much or little in a period of rising commodity prices. If reproduction cost increases and considerable weight is given to this factor, the fair value determined by a regulatory body would be greater than that arrived at in a period of lower prices.

If a general increase in commodity prices is added to the above assumptions, it is observed that the fair value of the net assets might increase with sufficient rapidity to offset capital impairment from the legal standpoint. Application of the rule of the definition might continue to indicate undercapitalization even though, legally, capital was continually being impaired.

Under the conditions of the omission of certain legitimate charges against earnings and the simultaneous payment of dividends, which impair legal capital, the application of the first definition of overcapitalization registers a condition brought about by error—a condition not fundamentally unsound.

IV. The fourth circumstance under which the first type of definition is to be observed is that of the issuance of capital stock for property actually worth less than the par value of the stock given for it.

Referring once more to the balance sheet of The Prime Corporation as of December 31, 1940, let it be assumed that on that date the corporation issued one thousand shares of common stock for a new factory building which could, under the conditions then existing in regard to materials and lower prices, be constructed for $75,000. It is, therefore, considered to be worth only $75,000. All other conditions, including the price level, remaining fixed, the fair value of the net assets might reasonably be $800,000, according to the method of determining fair value previously described. The following table shows the computations:

Total Assets before New Acquisition	$800,000
New Acquisition of Assets, Fair Value	75,000
Total	$875,000
Less Liabilities	75,000
Estimated Fair Value	$800,000

The par value of bonds and stocks is $600,000. Application of the rule of the definition indicates not overcapitalization but undercapitalization of $200,000. This undercapitalization is indicated by the definition in spite of the known fact that $25,000 too great a value of stock was issued for the newly acquired asset. Close observation will reveal that the reason for the test's not indicating overcapitalization is the existence of a surplus larger than the amount of over-issue of stock which just took place.

REASONS FOR REJECTION OF THE FIRST DEFINITION

In examining the definition which measures overcapitalization as the excess of par value of the securities over fair value of the net assets, it has been pointed out that this excess is meaningless as a measure of unsoundness under the conditions of a decrease in replacement costs, brought about by lower prices, because the difference may be the result of assets being expressed in the dollar of one period and par value being expressed in that of another. It has also been observed that the rule registers overcapitalization only under very definite conditions, that is, when legal capital is impaired and then only if fair value is not increasing sufficiently to offset the impairment while the corporation is operating at a loss. The definition has received further examination under conditions of capital impairment brought about by erroneous accounting procedure in regard to depreciation and obsolescence, as well as under certain conditions of actual overvaluation of assets. In each instance, it has been found unreliable as a barometer of economic unsoundness. The two principal reasons for the failure of the definition to function are:

1. Importance is attached to par value, which has no real significance.
2. Capital is conceived as consisting of par value of securities only.

THE PAR-VALUE FICTION

The definition of overcapitalization which uses par value as a basis of comparison is, as is well known, based upon a very common error: the false conception that stating the value of a share of stock or printing that value upon the face of a stock certificate produces an intrinsic value of that amount. Nothing is farther from the truth. The only way that a share of stock can be worth par value at the time of issue is to have assets in the form of cash or property paid in to the corporation in exchange for the stock. It is the value of the corporation's assets at that moment which imputes value to the capital stock. If the corporation has assets valued at $100 for each share of stock outstanding, the value of each share of stock is $100 even if the par value were stated to be $1.13. If the assets of the corporation represent a value of $1.13 for each share of stock outstanding, that is the value of each share of stock, although the certificate bears a par value of $100.

If, after the issue of capital stock at $100 a share, the corporation operates at a profit an additional fund of assets comes under its control and the capital stock, representing ownership of the corporate assets, may increase proportionately in value. Operation at a loss produces an opposite effect, and the assets upon which the value of stock is based will diminish. Indeed, if capital stock were issued at a premium or at a discount, par value would be insignificant even at the time of issue.

Nothing proves the lack of significance of par value more than the fact that so much no-par-value stock is in existence. It seems logical to conclude that a definition or a test based upon the use of an insignificant fiction can measure nothing of importance.

THE MISCONCEPTION OF CAPITAL AS PAR VALUE ONLY

Another important misconception in the test of overcapitalization is that of considering capital as consisting of par value only. There are two divisions of corporation capital (in a broad sense) according to source. Par value plus premium paid by stockholders or minus discount deducted from par value at time of issue is the one type called contributed capital. The other type is capital earned by the business. It consists of earnings not paid out as dividends, in other words reinvested earnings. These undistributed earnings should appear in the accounts as earned surplus; they are part of the stockholders' equity in the corporate assets. The earned surplus which remains invested in the business is as much a part of capital (in the broad sense) as is the par value of securities. It is as much a part of capital as it would be if the funds which it represents had been disbursed as dividends and recovered by a sale of capital stock. If dividends were paid amounting to $20,000 the following entry would be made:

Dr: Earned Surplus..............	$20,000	
Cr: Cash.....................		$20,000

If capital stock of $20,000 were immediately sold to the same stockholders, the transaction might be recorded as follows:

Dr: Cash.......................	$20,000	
Cr: Common Capital Stock.....		$20,000

Common capital stock has been increased $20,000, and earned surplus has been decreased $20,000. Everything else remains the same. The position of the stockholders has not been changed in any way by this transaction. The same result is reached by issuing a stock dividend of $20,000, recorded as follows:

Dr: Earned Surplus..............	$20,000	
Cr: Common Capital Stock.....		$20,000

A stock dividend may be viewed merely as a transfer of an amount from earned surplus to capital stock, stock certificates be-

ing issued as evidence of the transfer. The ultimate effect is merely that of a book entry which, one must admit, is incapable of the creation of capital. If the amount under consideration is capital after the transfer it must, therefore, have been capital previous to it.

Using par value as a measure, the definition under consideration is untenable under conditions of changed commodity prices, because it attempts to compare with par value another value stated in terms of a dollar with an entirely different purchasing power from that of the dollar in terms of which par value is stated.

Using only par value as a measure, the definition fails in detecting an economically unsound condition because it ignores the fact that a fund of assets should exist equal to surplus. It uses this fund of assets along with all other assets in determining fair value but fails to use the capital item of surplus representing stockholders' equities in that fund of assets.

SECOND TYPE OF DEFINITION EXAMINED

The second type of definition is that which states that overcapitalization exists when the par value of the capital stock exceeds the market value of the capital stock over a long period of time. It is immediately apparent that any factor which affects market value, producing either an upward or downward movement, must affect the application of this definition, since the par value with which it is compared is fixed. The examination of definitions of this second type will be carried on under the following conditions:

1. A general fall in commodity prices, which produces a decrease in replacement cost of assets.
2. Operation at a loss.
3. Operation at a profit.

Let it be assumed that The Segundo Corporation presented the following condensed balance sheet on December 31, 1940:

THE SEGUNDO CORPORATION
Balance Sheet, December 31, 1940

Assets	
Current Assets	$ 500,000
Fixed Assets (depreciated value)	1,500,000
Total Assets	$2,000,000
Liabilities and Capital	
Current Liabilities	$ 200,000
Fixed Liabilities (bonds)	500,000
Capital Stock (par value, $100)	1,000,000
Earned Surplus	300,000
Total Liabilities and Capital	$2,000,000

In order to observe the effect of a general decrease in commodity prices, let it be assumed that, during the next two years, the operating costs of The Segundo Corporation were adjusted to a lower dollar volume of sales.[11] The possibilities of such an adjustment were discussed in the instance of The Prime Corporation. The final result may be that the corporation is operating at a profit—wage earners, bondholders, and stockholders being in positions somewhat comparable, in terms of real income, to their former positions. However, under the existing lower level of commodity prices, which produces a lower cost of living, the bondholders and preferred stockholders are in a slightly better relative position, because their interest and dividends are fixed in terms of the dollar. Changes in cost of living applicable to their station in life necessarily change the real income of preferred stockholders and bondholders. Let it be assumed that prices continued at approximately the same heights for, say, five years. Although the security markets are unpredictable, it may be conceded that the market value of the capital stock in general and of The Segundo Corporation in particular, might range considerably lower than under the assumed conditions of 1940, if

[11] This is not to be taken as an indication that the dollar volume of sales will necessarily be lower. The ultimate effect of price changes might be in some instances an increase in dollar volume brought about by an increased physical volume.

other market factors do not prevent the lower prices from being reflected in the market. If it is assumed that the market value of a share of common stock of The Segundo Corporation averaged $112 in 1940, under the lower price level, it might average $85 during the five years following 1942. This average is $15 a share under par value. Application of the definition indicates so-called overcapitalization of $150,000, computed as follows:

Par Value of 10,000 Shares of Common Stock	$1,000,000
Market Value of Common Stock, 10,000 shares @ $85	850,000
Indicated Overcapitalization	$ 150,000

It is evident, from the discussion of these possible conditions of operation under a lower dollar volume of sales and from general observation, that a corporation is not necessarily unsound if it issues capital stock at the peak of an era of high prices and finds that it must operate for many years to come under a considerably reduced price level. Yet application of the definition of this type might, in comparing market value and par value of the stock, continually register so-called overcapitalization.

The next condition under which the effect of the second type of definition is to be observed is that of operation at a loss. If all other things including commodity prices in general remained unchanged, and if The Segundo Corporation operated at a loss for a few years following 1940, it is logical to assume that the market value of the corporation's stock might fall below par value. Application of the definition, which uses market value of the stock for comparison, would indicate overcapitalization. In so doing, it detects an unsound condition—a condition resulting from operation at a loss. This second test of so-called overcapitalization spots unsoundness much more quickly than the first type. This second type substitutes market value of stock for the fair value of assets, and is, therefore, much more sensitive to the effect of the ability of the corporation to make profits. However, speculators' preferences are so fickle that it cannot be said with certainty that even operation at a loss for several years would drive market value below par value, especially if a large earned surplus existed, and if the market price had previously been far above par value. This uncertainty, which makes it difficult to fix the weakness of such a definition, is, of course, one of the best arguments against the probability of the definition's being a significant test of unsoundness, simply because the market price of the stock does not vary directly with the concern's ability to make profits.

The fair value of the corporation's assets must have some relation to the market value of the capital stock, even though it be a vague and shifting one. It seems logical to assume, other conditions including earnings being fixed, that the market value of the stock of a corporation would be higher when it had a large fund of assets than when it had a fund of assets which was comparatively smaller. Let it be assumed that current assets of The Segundo Corporation on December 31, 1940, included, in adition to the $500,000 shown in the balance sheet, U. S. Government bonds worth $200,000 (market value). The market value of the stock ought to be $20 a share higher under this condition than under the conditions shown in the balance sheet above, if earnings and all other conditions remain as before. The market value ought to be higher because each share of stock has an equity of $20 of very liquid assets, which does not exist under the other condition. The amount would not be $20 at all times, of course, since bond values themselves fluctuate. If, under the initial conditions, the capital stock were selling at $120 a share in 1940 and dropped to an

average of $80 for a few years succeeding 1940, when such additional assets worth $20 are placed behind each share, it ought to have been selling at $140 in 1940, and it ought to have dropped to an average of $100 in succeeding years. (All factors except this extra asset value are fixed.) Since it has, under the latter assumptions, not fallen under par value, no so-called overcapitalization is indicated by the test of the definition, whereas the same conditions of operation exist under which overcapitalization was detected before the additional assets were assumed to exist. Including this additional fund of assets, earned surplus would total $500,000 instead of $300,000. It is, therefore, observed that the additional fund of assets, which earned surplus represents, affect the result of the application of this type of definition.

The above definition is untenable in that its detection of unsoundness, indicated by long operation at a loss, is affected by the amount of the earned or any other kind of surplus which represents a fund of assets in addition to that represented by the par value of the capital stock. The same fundamental weakness recognized in the first type of definition exists in the second type in that bookkeeping entries can correct the so-called overcapitalization. Any amount of so-called overcapitalization not exceeding $1,000,000 can be eliminated by reducing par value or by cancelling some of the capital stock, and recording the par value of the stock cancelled as a debit to Capital Stock account and a credit to Capital Surplus account. As has been previously explained, this adjustment in no way affects equities of stockholders or the soundness of the corporation so long as the capital surplus thus created is not disturbed.

The proponents of this definition specifically define its antithesis as undercapitalization. If a condition existed in which the market value of the capital stock exceeded the par value over a long period of time, a condition of undercapitalization would be declared to exist. If this excess were estimated at $100,000, the payment of a stock dividend and the following bookkeeping entry would eliminate the so-called undercapitalization:

Dr: Earned Surplus............	$100,000	
Cr: Capital Stock............		$100,000

It is, therefore, recognized that the second type of definition, which uses market value of capital stock as a basis of comparison, has many of the same weaknesses as were found in the use of fair value of the corporation's assets as a basis of comparison.

The second type of definition will next be observed under conditions of operation at a profit. If The Segundo Corporation operated at a profit following 1940, and allowed an accumulation of earned surplus to take place, the market value of the capital stock would have a tendency to rise gradually if all other factors affecting market value were held constant. The rise would be produced by the gradually increasing fund of assets represented by the increased surplus. The application of the second type of definition would register increasing undercapitalization. As has just been pointed out, this so-called undercapitalization could be eliminated by the issue of stock dividends. In addition, it must not be overlooked that continually reducing earned surplus and the fund of assets by the payment of cash dividends prevents or eliminates this so-called undercapitalization.

Let it be assumed that one other condition, the price of commodities in general, be allowed to shift. If prices move downward, and if we assume that they exert just enough influence to decrease the market value of the capital stock each period by the same amount that net earnings not distributed to stockholders increase earned surplus, the approaching so-called undercapitalization comes to a standstill. If the

market value of the capital stock falls more rapidly than the accumulation of surplus increases, overcapitalization, according to this definition, will at some point in the process be indicated even when the corporation is operating at a sizable profit and is financially sound.

REASONS FOR REJECTION OF THE SECOND TYPE OF DEFINITION

The conclusions in regard to the second type of definition are that it leads to inaccurate indications of unsoundness, referred to as overcapitalization and undercapitalization, under conditions of changing commodity prices and of operating either at a profit or at a loss. It must be rejected because of the primary misconceptions of treating par value as a significant value and regarding capital as being constituted only of par value to the exclusion of the very important earned surplus element of capital.

EXAMINATION OF THIRD TYPE OF DEFINITION

The third type of definition states that overcapitalization exists when the par value of securities exceeds the capitalized income yield of the business. This is the type of definition an economic theorist is liable to support. In the background of this definition is the theory that the value of property, and therefore its cost, ought to be equal to the capitalized income yield of its production. For obvious reasons this relationship is rarely attained in practice.

This definition, which uses the value of capitalized income yield as one criterion of overcapitalization, has much more theoretical significance than the other definitions considered here. In treating the income yield, it considers the ability of a business entity to earn a fair return on the capital invested in it—the primary justification for its economic existence.

In order to judge this definition on its merits under chosen circumstances, it will be applied under conditions of:

1. All factors as nearly static as possible.
2. A change in commodity prices in general.
3. Operation at a profit and accumulation of a surplus, actual rate of income yield being equal to anticipated rate.
4. Operation at a profit and accumulation of a surplus, actual rate of income yield being less than anticipated rate.

An enterprise in actual economic life obviously must operate under one or more of the above conditions. The failure of a definition to prove significant under any one of the conditions justifies its rejection as a reliable measure of any unsound condition.

Following is the condensed balance sheet of The Tertiary Corporation as it is assumed to appear on December 31, 1940, immediately after organization to begin operation:

THE TERTIARY CORPORATION
Balance Sheet, December 31, 1940

Assets	
Current Assets	$250,000
Fixed Assets (Cost)	500,000
Total Assets	$750,000
Liabilities and Capital	
Current Liabilities	$ 50,000
Fixed Liabilities (Bonds)	200,000
Capital Stock	500,000
Total Liabilities and Capital	$750,000

Let it be assumed that the $500,000 par value of capital stock was invested in equipment, the purchase price of which was agreed upon as an amount equal to the estimated net earnings capitalized at the rate of ten per cent. The equipment was set up for the purpose of carrying on, under a ten-year lease, the exploitation of a natural resource, and at the end of ten years will be worthless. Let it also be assumed that a ten-year contract was executed with a user of the natural resource to dispose of the definite amount of annual production

allowed under the terms of the lease at a fixed price. Now, if by hypothesis all factors in business remain stationary, wages and other costs of production may reasonably be expected to be forecast with almost complete accuracy. If the other assets are unproductive except that they serve in an auxiliary capacity in the operation of the business, if all excess assets resulting from the conversion of fixed assets into current form through sales are used to retire the capital stock at par value as soon as a sufficient excess exists, and if all net earnings are distributed to the stockholders, it seems that the corporation has met all of the requirements of this definition for being properly capitalized. Under these static conditions the definition reacts properly in adjudging economic soundness.

The fact that so many factors were assumed to be static (a condition which is not likely to exist in real life), leads one to suspect that proper capitalization, defined as the condition in which par value and the amount of the capitalized income yield are equal, may be difficult to attain. There are still possibilities of changing factors not included in the illustration above, for example, the possibility of an increasing supply cost of labor to the industry.

In order to observe the operation of the test of overcapitalization stated in the third type of definition under conditions of decreased commodity prices, let all the restrictions set up for The Tertiary Corporation be abandoned. Let it be assumed that fixed assets were purchased in the ordinary course of organization to operate in an established industry. The life of the fixed assets is still assumed to be ten years.

Let it be assumed that commodity prices in general decreased considerably, and that the cost of living decreased approximately twenty per cent by 1942, and continued at or close to this lower level for the remainder of a ten-year period. Let it be assumed further that The Tertiary Corporation adjusted itself to a lower dollar volume of income, as it was assumed that The Prime Corporation and The Segundo Corporation did. This assumption conforms to adjustments which actually take place in the business world. The bondholders are the only individuals involved whose positions have been bettered. (The reason for this was explained in connection with The Prime Corporation.) To carry the argument a step further, it might also be assumed that the bonds were sold at a price which anticipated an approaching lower price level. The result is that the corporation is earning a return on its capital stock not so great in dollar value as anticipated.

If the third type of definition of overcapitalization is applied to this situation, and if the revised estimate of, or actual figures for the income yield are capitalized at the selected rate, a capitalized value smaller than the par value of the capital stock will be produced. This excess of par value over the amount obtained by capitalizing the income yield indicates overcapitalization according to the rule of this definition.

To clarify this matter, let it be assumed that the original estimate of income made at the inception of the corporation was an annual average of \$50,000, which is ten per cent on the par value of the capital stock. If the yield in 1940 were \$50,000, in 1941, \$45,000, and in the remaining eight years average \$40,000 a year, the total income yield for the ten-year period[12] would be \$415,000, or an average of \$41,500 a year. Capitalization on the basis of the original estimate of ten per cent produces the above amount of \$415,000 (\$41,500 ÷ .10), which is the capitalized actual income yield for the period.[13] The par value of the stock, \$500,000, exceeds this amount by \$85,000

[12] Ten years is selected merely for purposes of demonstration. The actual average income of a corporation can, of course, be known only at the end of its life.

[13] The actuarial error in this computation is disregarded.

which is the indicated overcapitalization.

Since by the hypothesis the corporation is economically sound, the third type of definition, based upon the capitalized income yield, leads to an erroneous conclusion regarding overcapitalization.

Brief consideration of the effect of an increase in commodity prices, which comes about after the corporation is organized and continues for a long period, leads to the conclusion that application of the definition to such a situation would probably indicate the antithesis of the above results, that is, a condition of so-called undercapitalization. Such a condition would be indicated even though, in the era of higher prices, the stockholders were enjoying almost the same amount of real income as they previously enjoyed from the operation of the corporation. The erroneous conclusion that overcapitalization exists is the result of the use, for purposes of comparison, of an amount obtained by capitalizing an income yield inflated in dollar value. In this instance, the capitalized value of the income yield is greater than par value, since par value was fixed in a period of lower prices.

The individuals who conceive overcapitalization according to this third type of definition have said nothing about the detection of overcapitalization when the corporation operates at a profit and allows some of the profits to remain in the business as earned surplus. They make no statements which lead to the conclusion that they would exclude, in the capitalization of the income yield, the additional earnings attributable to the new fund of assets represented by the reinvested earnings. They have simply used the two terms "capitalized income yield" and "par value" without qualification.

In order to observe the effect of an accumulation of surplus upon this test of overcapitalization, let it be assumed that, without an appreciable change in commodity prices, The Tertiary Corporation allowed a surplus of $500,000 to accumulate and invested the funds obtained from profits in additional fixed assets to take care of its expanding business. If the anticipated rate of return is secured on both the original investment and the reinvested earnings, no undercapitalization or overcapitalization ought to appear; for realization of the anticipated income yield is the very basis of proper capitalization by this definition. However, application of the definition indicates so-called undercapitalization if the enlarged income yield, because of increased investment in assets, is included in the computation. If any one argues that this additional yield attributable to assets not in the original balance sheet would be excluded, let it be excluded. The original investment, then, is properly capitalized. But what of the additional earnings? The answer, applying this definition, must be that that part of the business is 100% undercapitalized. The only logical conclusion is that undercapitalization as thus defined is meaningless in the light of the definition of economic soundness previously given.

In order to observe the application of the definition to a corporation which has failed to earn the anticipated rate of income yield, let it be assumed that The Tertiary Corporation was capitalized originally on the basis of an expected ten per cent yield. If the corporation at first failed to secure the anticipated return, having realized only a seven per cent yield on capital stock, it might be attributed to the fact that the enterprise was not organized upon the most efficient scale of production, and that all or most of the earnings might be retained and invested in additional fixed assets until the desired scale of production was reached. Let it be assumed that The Tertiary Corporation followed this procedure and at the end of eight years presented the following balance sheet:

THE TERTIARY CORPORATION
Balance Sheet, December 31, 1948

Assets	
Current Assets	$ 300,000
Fixed Assets	750,000
Total Assets	$1,050,000
Liabilities and Capital	
Current Liabilities	$ 60,000
Fixed Liabilities	200,000
Capital Stock	500,000
Earned Surplus	290,000
Total Liabilities and Capital	$1,050,000

If the corporation has attained an average rate of earnings of ten per cent on capital stock of $500,000, that is, average annual earnings of $50,000, it is actually earning only 6.3% on the stockholders' equity of $790,000. Income yield ($50,000) capitalized at ten per cent equals $500,000 capitalized income yield. Par value and capitalized income yield are equal, and, according to the definition, no overcapitalization exists, yet the yield is actually lower than before the expansion took place

REASONS FOR REJECTION OF THE THIRD TYPE OF DEFINITION

The definition of overcapitalization as the excess of par value of capital over the capitalized income yield of the business enterprise has been examined under circumstances in which all factors were held as nearly static as possible. It was found to be capable of measuring a condition of so-called overcapitalization or of proper capitalization, which might be considered to be of some significance. However, even the existence of this type of so-called overcapitalization does not necessarily indicate unsoundness. The fact that the enterprise earns only seven per cent, when it was organized upon the anticipation of a ten per cent income yield, does not necessarily mean that the enterprise is unsound. The definition is rejected for the reason that its concept of overcapitalization is not necessarily synonymous with economic unsoundness of the enterprise.

The definition has been examined under circumstances of a change in commodity prices and of operation at a profit with the rate of actual income yield equal to and less than the anticipated income yield. The definition is rejected because in each instance it has been unreliable as an indicator of unsoundness. This unreliability is the result of:

1. Failure to recognize the effect of changes in commodity prices in general upon a comparison of values stated in terms of the prices of different periods.
2. Failure to recognize the insignificance of the par value of capital stock.
3. Failure to recognize surplus as a legitimate and necessary part of capital.
4. Considering all discrepancies between par value and capitalized income yield as indications of unsoundness.

THE POSSIBILITY OF A RELIABLE DEFINITION OF OVERCAPITALIZATION

Having determined that the fundamental weakness in the definitions examined was in relation to the use of par value and the failure to consider surplus as a part of capital, the possibilities of formulating a definition not subject to these criticisms will be discussed.

In the beginning, an understanding of the sort of condition which is being defined must be established. In none of the definitions which have been presented have the authors stated what condition they were defining. They have implied by the term overcapitalization that the corporation has outstanding too great a par value of capital stock in proportion to assets. The real significance or lack of significance in this condition has not been approached scientifically. The examination given the several definitions has disclosed the fact that, for the most part, the application of the definitions to specific instances results in branding as overcapitalized a corporation which is economically sound. In other instances, no overcapitalization is registered even when the corporation operated at a

loss for a long period of time. The conclusion must be that the authors have spoken casually of overcapitalization and undercapitalization without having established in their own minds the economic significance or lack of economic significance of the conditions which they have described as overcapitalization or undercapitalization. It will be recalled that the criterion of economic soundness by which the different types of definitions have been evaluated is the ability of an enterprise, over a long period of time, to earn a fair return in terms of real income upon total capital.

A corporation found, by this rule, to be economically unsound may be adjudged unsound because it has more capital invested than it can earn a fair return upon. Perhaps with a more efficient organization the business could produce the same income with less capital; in this sense it may be said to be overcapitalized. However, a fundamentally weak point exists in a conclusion formed on the basis of these conditions. The actual situation may be that the firm is of less than optimum size, and that additional investment might increase earnings to a fair return on all capital. One who makes the test is, therefore, confronted with an anomalous condition. The detected unsoundness may be the result of either too much capital or too little capital.

Economic soundness has been defined in such terms that the effect of changes in price levels are taken into account as far as possible. Capital may be stated in terms of dollars of par value of capital stock and in terms of dollars of surplus. The par value of capital stock may be stated in dollars of one price level, and part or all of the surplus may be stated in terms of some other price level. If the actual return in terms of real income on the stockholders' investment in capital stock and surplus is sufficient to prevent the withdrawal of capital from the industry, it is considered a fair return. To determine a rate of income yield, the dollar value of net earnings is not applied to the dollar value of capital. Hence the effect of price levels upon the comparison has been eliminated as far as possible.

Operation at a profit and operation at a loss, under which conditions the definitions of overcapitalization and undercapitalization were found to be unreliable, are the principal criteria of economic soundness and unsoundness as previously defined. The accumulations of surplus do not affect the application of this definition, since surplus is included as a part of capital. The fund of assets which surplus represents, or for that matter the fund which capital represents, is not valued in any way for comparative purposes. The whole test is based upon consideration of whether or not the net assets used in the business—this is the same as total capital—are being employed to produce a return upon total capital sufficient to prevent its withdrawal from that industry.

It is thus observed that the definition of economic soundness which has been formulated is reliable under changes of price level, operation at a profit or loss, and under conditions of large or small accumulations of surplus. It is not, however, a definition of overcapitalization or of undercapitalization.

CONCLUSIONS CONCERNING OVERCAPITALIZATION

None of the definitions of overcapitalization or undercapitalization considered in this study have any significance. It has been shown that they fail to detect conditions which are economically unsound according to the definition used here. Neither are they useful in determining economic soundness as distinguished from the concepts of overcapitalization and undercapitalization. It has been shown that they fail on two major points: (1) the concept of

capital as constituted of par value only, and (2) the disregard of important changes in price level.

A definition of economic soundness free from these criticisms has been formulated. However, all that the definition indicates is that a corporation has earned or has failed to earn a fair return in terms of real income on the dapital invested. The conclusion has been reached that what this definition indicates is all that any comparison of net earnings, par value, surplus or other information taken from the accounting records can indicate. Whether in any particular instance a corporation could be expected to earn a fair return with less capital or more capital is determined by facts and conditions outside the accounting records. Such questions are to be determined from an analysis of the market and of the internal functioning of the corporate enterprise within an industry. For example, if the corporation dominates an industry, it is conceivable that its product might glut the market and reduce the corporate earnings below a fair rate. It is also conceivable that withdrawal of capital might reduce the output to a basis which would allow a fair return. Moreover, it can be conceived with equal facility that the corporation might have insufficient capital to produce on the efficient scale which would assure a profit. Even though a larger scale of production might mean lower sales prices, the operating costs might be proportionately lower and thus account for increased earnings.

These illustrations from a host of possible situations indicate that the unsoundness detected from the accounting records may mean either overcapitalization or undercapitalization in the sense of too much or too little capital. It must be concluded that overcapitalization or undercapitalization cannot be determined from the accounting records and that these terms have no accounting or financial significance.

PROFESSIONAL EXAMINATIONS
A Department for Students of Accounting

HENRY T. CHAMBERLAIN

THE FOLLOWING problems were prepared by the Board of Examiners of the American Institute of Accountants and were presented on November 13, as the first half of the C.P.A. Examination in accounting theory and practice. The examinees were allowed six hours to solve these problems and weights were assigned as follows: problem 1, 12 points; problem 2, 4 points; problem 3, 16 points; problem 4, 12 points; problem 5, 6 points.

A suggested time schedule is given below:

Problem 1	60 minutes
Problem 2	15 minutes
Problem 3	120 minutes
Problem 4	90 minutes
Problem 5	30 minutes

No. 1

A depreciation schedule for auto trucks of the Way Mfg. Co. was requested by an income-tax revenue agent soon after December 31, 1940, showing the additions, retirements, depreciation, and other data affecting the taxable income of the company in the four-year period 1937 to 1940, inclusive. The following data were ascertained;

Balance of auto trucks account Jan. 1, 1937:	
Truck No. 1 purchased Jan. 1, 1934, cost..	$2,000
Truck No. 2 purchased July 1, 1934, cost..	1,800
Truck No. 3 purchased Jan. 1, 1936, cost..	1,200
Truck No. 4 purchased July 1, 1936, cost..	1,000
Balance Jan. 1, 1937....................	$6,000

The auto trucks depreciation reserve account prevously adjusted by a revenue agent to January 1, 1937, and duly entered in the ledger, had a balance on that date of $2,440 being depreciation on the four trucks from the respective dates of purchase, based on a five-year life. No charges had been made against the reserve prior to January 1, 1937.

Transactions between January 1, 1937, and December 31, 1940, and their record in the ledger were as follows:

July 1, 1937. Truck No. 1 was sold for $600 cash; entry debited cash and credited auto trucks, $600.

January 1, 1938. Truck No. 3 was traded for a larger one (No. 5), the agreed purchase price of which was $1,600. The Way Mfg. Co. paid the automobile dealer $780 cash on the transaction. The entry was a debit to auto trucks and a credit to cash, $780.

July 1, 1939. Truck No. 4 was damaged in a wreck to such an extent that it was sold as junk for $50 cash. Way Mfg. Co. received $300 from the insurance company. The entry made by the bookkeeper was a debit to cash, $350 and credits to miscellaneous income $50 and auto trucks $300.

July 1, 1939. A new truck (No. 6) was acquired for $1,200 cash and was charged at that amount to the auto trucks account.

Entries for depreciation had been made at the close of each year as follows: 1937, $1,200; 1938, $1,076; 1939, $1,076; 1940, $1,246.

(a) For each of the four years calculate separately the increase or decrease in net profits arising from the company's errors in determining or entering depreciation or in recording transactions affecting trucks, ignoring any effect that income-tax regulations concerning gain or loss on trade-ins may have on the profits.

(b) Prove your work by one compound journal entry as of December 31, 1940, the adjustment of the auto trucks account to reflect the correct balances as revealed by the income-tax schedule, assuming the books have not been closed for 1940.

No. 2

The City Bus Company operates on a revenue basis of 10 cents for a single ride and 8 cents a ride when coupon tickets are bought in advance in "books" of ten.

(a) Prepare journal entries for the following transactions and adjustments:

(1) Sale of 310 "books" for cash
(2) Aggregate drivers' reports received accompanied by corresponding cash and tickets, viz.:
 Cash $100 (all from cash fares)
 Coupon tickets, 3,000 in number
(3) Any adjustment you think desirable for the purpose

of stating the revenue from transactions in (1) and (2), and showing the "liability" on tickets still outstanding.

(b) Comment briefly on the system used by the bus company in accounting for passenger revenue, as you visualized it in making the entries.

No. 3

Prepare a schedule showing sales, costs, and operating net income for each line of goods distributed by the Argo Grocery Company. Furnish supporting schedules indicating clearly how the items of expense have been apportioned. Show results only to the nearest dollar.

The Argo Grocery Company manufactures and distributes in a limited area two lines of grocery products. One line is distributed to hotels and restaurants, the other to retail grocers. Selling organizations for the two lines are separately set up and operated, and there is considerable rivalry between them. There is also a good deal of argument about which line nets the greater income to the company. Total dollar volumes of the two lines are roughly equal, but on account of competititve conditions the margins in the restaurant line are relatively narrow while wider margins are enjoyed by the retail line. From this fact the sales manager for the retail line argues that his line contributes more to the company's net income. The restaurant sales manager, however, insists that the distribution costs per dollar of sales for his line are sufficiently lower to make up for the difference in margin.

In an attempt to settle the argument the following facts about the company's 1940 business have been ascertained:

Both lines are stored in a single warehouse, and packing and shipping activities are carried on by the same crew. The restaurant line consists of ten items and is sold in shipping containers supplied by the factory and included as part of factory cost. The retail line consists of fifty items. The goods must be assembled and packed in containers after orders are received. Time studies indicate that it takes about four times as long to prepare $100 worth (at selling price) of retail goods for shipment as in the case of restaurant goods. Restaurant goods are delivered at the warehouse dock to customers' trucks or to common carriers; in the latter case the customers pay the freight. The company's own delivery equipment is used entirely for the retail line.

Advertising is directed entirely at the ultimate consumer, with the aim of persuading him to demand the company's products at stores and in public eating places. It consists of newspaper advertising and of display matter and leaflets supplied to dealers. About 10% as much newspaper space is devoted to the restaurant line as to the retail line. The company's advertising staff consists of one man, who spends two thirds of his time on newspaper advertising and the balance on display and leaflet material.

Schedule 1 lists the operating expenses of the company other than those concerned with manufacturing. Schedule 2 lists important operating data ascertained in the course of your investigation. The apportionment of office and clerical time is the result of time studies and estimates. It is the opinion of the management that office supplies and equipment expense roughly parallels the office and clerical salaries. The management rejects as inadmissible the inclusion of interest on investment. Approximately one-half of the time of credit and collection employees is spent in routine checking orders for credit approval. The balance is spent on credit follow-ups and attempts to collect specific accounts. Experience indicates that the average retail account is about five times as likely to require such collection effort as the average restaurant account. Historical records show that about ½ of one per cent of retail

sales are never collected, while only 1/10 of one per cent of restaurant sales prove to be uncollectible.

Ninety per cent of the job of keeping warehouse stock records is concerned with shipments and 10% with receipts from the factory. All items of the restaurant line are received at the warehouse every day, but items in the retail line are received on the average only every other day.

SCHEDULE 1

EXPENSE DATA

Sales force salaries and expense:	
Restaurant line	$15,000
Retail line	35,000
Warehouse depreciation, insurance, etc.	4,000
Packing and shipping wages	10,000
Shipping containers	800
Other shipping supplies (proportionate to number of sales invoices)	600
Delivery wages, supplies, and expense	3,000
Newspaper advertising	11,000
Display material and dealers' helps	2,500
Advertising salary	1,650
Office and clerical salaries (see schedule 2)	5,000
Office supplies and equipment expense	1,600
Executive salaries and expense (apportion on basis of sales)	8,000
Bad debts allowance	1,590
Total	$99,740

SCHEDULE 2

OPERATING DATA

	Restaurant	*Retail*
Sales	$240,000	$270,000
Factory cost of sales	$200,000	$180,000
Warehouse space occupied by $100 worth, at cost	30 cu. ft.	60 cu. ft.
Average inventory, at cost	$ 20,000	$ 40,000
Number of sales invoices	1,000	9,000
Average number of items per invoice	4	12
Number of customers	28	224
Average customers' accounts outstanding	$ 20,000	$ 40,000
Analysis of office and clerical time:		%
Keeping warehouse stock records		5
Preparing order and sales invoice forms		25
Posting sales invoices		15
Receiving cash and posting cash receipts		5
Preparing customers' statements		5
Credit and collection activities		10
General accounting and clerical (apportion on basis of sales)		35
		100

No. 4

From the following trial balance of Young & Co., Inc., before closing of its second year on June 30, 1940, and from the additional data given, prepare a columnar work sheet showing in separate columns the adjustments applied to the trial balance and the resulting adjusted balances, the latter segregated into balance-sheet and profit-and-loss account columns:

TRIAL BALANCE

	Dr.	*Cr.*
Cash	$ 52,475	
Accounts receivable	320,000	
Reserve for bad debts		$ 650
Materials and goods in process—June 30, 1939	65,000	
Finished goods—June 30, 1939	158,000	
Insurance unexpired—June 30, 1939	3,000	

Land	200,000	
Buildings	300,000	
Reserve for depreciation of buildings		6,000
Machinery and equipment	148,500	
Reserve for depreciation of machinery and equipment		11,250
Reserve for replacements		15,000
Sinking fund trustee	25,000	
Discount on bonds	25,000	
Treasury stock	35,000	
Accounts payable		40,000
Bond interest accrued		3,125
Taxes accrued		9,000
First mortgage 5% sinking fund bonds		226,250
Capital stock		500,000
Premium on capital stock		50,000
Stock donation		60,000
Reserve for bond sinking fund		25,000
Surplus—June 30, 1939		60,000
Sales, less returns and allowances		915,000
Purchases of materials	305,000	
Labor	132,800	
Operating expenses, repairs, etc.	121,500	
General expenses	17,500	
Bond interest	12,500	
	$1,921,275	$1,921,275

Additional Data

1. The $500,000 share capital had been issued at a 10 per cent premium to the vendors of the property on June 30, 1938, the date on which the company was organized. Stock in the amount of $60,000 par was donated by the vendors and was recorded by a debit of that amount to "Treasury stock" and a credit to "Stock donation." It was donated because land and buildings had not been valued accurately when entered on the books and the proceeds were to be considered as an allowance on the purchase price of land and buildings in proportion to their values as first recorded. The stock was sold in the latter part of 1938 for $25,000 which amount was credited to "Treasury stock."

2. On June 30, 1940, a machine, which cost $6,000 when the business was started, was removed and replaced by a similar machine costing $10,000, which amount was charged to "operating expenses, repairs, etc." The replaced machine had been depreciated at 7½ per cent during the first year.The only entry made was one crediting "machinery and equipment" with its sales price of $1,500.

3. Depreciation of buildings is to be provided at 2 per cent annually and of machinery and equipment at 7½ per cent.

4. The inventories at June 30, 1940, were

Materials	$ 52,000
Goods in process, cost	105,000
Finished goods, cost	137,000

5. The company decided to maintain a reserve for bad debts equal to one per cent of the accounts receivable outstanding on June 30th. Accordingly $3,000 had been set aside at June 30, 1939, against which the bad debts of the year ended June 30, 1940, had been written off.

6. Three years' insurance is carried on buildings, machinery, and equipment and a premium of $4,500 had been paid on July 1, 1938.

7. The first mortgage 5 per cent sinking-fund bonds mature in 10 years from July 1, 1938, with interest payable on April 1st and October 1st. They were sold on July 1, 1938, at 90 and the discount is to be written off over the life of the bonds on the straight-line basis.

8. A sinking fund and a sinking-fund reserve are built up on the straight-line basis with a provision that instalments after the first shall be decreased by the amount of the annual 5 per cent interest accretion to the fund, which interest is to be added both to the fund and to the reserve.

9. It is learned from the records that the proper instalment to the sinking fund was paid by the company on June 30, 1940, but that the amount was charged in error to the first mortgage 5 per cent bond account.

10. The sinking-fund trustee reports that he added $1,250 interest to the fund on June 30, 1940. This had not been recorded by the company.

11. During the year ended June 30, 1940, taxes were charged at $3,000 monthly to "Operating expenses, repairs, etc." and "Taxes accrued" were credited. The taxes paid during the year amounted to $27,000. The taxes are assessed each time for the year ended March 31st.

12. A dividend of 10 per cent on the outstanding stock was declared June 25th, payable July 15, 1940.

No. 5

A client of yours asks about several different methods for valuing inventories of merchandise that have come to his attention recently. He names them as follows and asks you to tell him what they mean and to describe the essential characteristics of each:

Retail
Base stock
Last-in, first-out
Cost or market

Write a brief reply to the inquiry in summary (rather than letter) form. Please observe this does not ask for a discussion of the relative merits of the methods.

Solution to Problem 1

WAY MFG. CO.
Depreciation Schedule
January 1, 1937 to December 31, 1940

Date Acquired	Date Sold	Truck Number	Asset Dr.	Asset Cr.	Reserve for Depreciation Dr.	Cr. 1-1-37	Cr. 1937	Cr. 1938	Cr. 1939	Cr. 1940	Cr. Total
1-1-34	7-1-37	1	$2,000.00	$2,000.00	$1,400.00	$1,200.00	$ 200.00				$1,400.00
7-1-34		2	1,800.00			900.00	360.00	$360.00	$180.00		1,800.00
1-1-36	1-1-38	3	1,200.00	1,200.00	480.00	240.00	240.00				480.00
7-1-36	7-1-39	4	1,000.00	1,000.00	600.00	100.00	200.00	200.00	100.00		600.00
1-1-38		5	1,600.00					320.00	320.00	$320.00	960.00
7-1-39		6	1,200.00						120.00	240.00	360.00
Balance				4,600.00	3,120.00						
			$8,800.00	$8,800.00	$5,600.00	$2,440.00	$1,000.00	$880.00	$720.00	$560.00	$5,600.00

(a) *Correction of Net Income*

	1937	*1938*	*1939*	*1940*
Depreciation (per books)	$1,200.00	$1,076.00	$1,076.00	$1,246.00
Depreciation (as corrected)	1,000.00	880.00	720.00	560.00
Excessive depreciation (per books)	$ 200.00	$ 196.00	$ 356.00	$ 686.00
Profit on trade-in of Truck No. 3 not recorded		100.00		
Less: Loss on Truck No. 4			*50.00*	
Sale of scrap taken up as income			*50.00*	
Increase in net income	$ 200.00	$ 296.00	$ 256.00	$ 686.00

(b) *Auto Trucks*

	Per books Dr.	Per books Cr.	As recomputed Dr.	As recomputed Cr.
	$6,000.00	$ 600.00	$6,000.00	$2,000.00
	780.00	300.00	1,600.00	1,200.00
	1,200.00		1,200.00	1,000.00
Balance		7,080.00		4,600.00

Reserve for Depreciation

	Per books Dr.	Per books Cr.	As recommended Dr.	As recommended Cr.
		$2,440.00	$1,400.00	$2,440.00
		1,200.00	480.00	1,000.00
		1,076.00	600.00	880.00
		1,076.00		720.00
		1,246.00		560.00
Balance	$7,038.00		3,120.00	

Reserve for depreciation of trucks	$3,918.00	
Auto trucks		$2,480.00
Profit and loss (correction for prior years)		752.00
Depreciation expense		686.00

COMMENTS

(1) In accordance with the requirements of (a) income-tax regulations are ignored in this solution.

(2) For income-tax purposes Truck No. 3 will have a basis of $1500 and the gain of $100 on the trade-in will not be subject to tax. No gain or loss will be recognized for tax purposes on the scrapping of Truck No. 4 since the involuntary cnoversion rule would seem to apply and the basis for Truck No. 6 would then be $1,250.

Solution to Problem 2

(a) 1. Cash	$248.00	
Unearned income-ticket books		$248.00
To record sale of 310 books at $.80		
2. Cash	$100.00	
Income from fares		100.00
To record cash fares per drivers' reports.		

3. Since the problem indicates that an adjustment is made at the end of the accounting period for ticket transactions, it would appear that income earned on tickets used is not recognized in the accounts until the end of the period. The entry would be:

Unearned income-ticket books	240.00	
Income from fares		240.00
To record income earned on 3000 tickets used.		

(b) *Entry 1.*

In arriving at the sale of 310 books consideration was given to the opening inventory of books, books printed during the period and the ending inventory. Proper controls are assumed to exist.

Entry 2.

Drivers' daily reports of cash and ticket fares are tied up to register readings and agree with cash and tickets turned in. The cash receipts from fares are recorded daily.

Entry 3.

A periodic summary is prepared of drivers' daily reports of tickets collected and this summary is the basis for the entry taking up income on tickets collected. Eventually the balance of $8 unearned will be written off to income when the coupon tickets are collected or when, after the lapse of an "experience" period, reasonable estimates are possible of the number of purchased coupon tickets that will not be presented.

Solution to Problem 3

ARGO GROCERY COMPANY

Statement of Profit and Loss

Date to Date

	Restaurant Line	*Retail Line*	*Total*
Sales	$240,000.00	$270,000.00	$510,000.00
Cost of sales	$200,000.00	$180,000.00	$380,000.00
Sales force salaries and expense	15,000.00	35,000.00	50,000.00
Warehouse depreciation, insurance, etc. (Schedule I)	800.00	3,200.00	4,000.00
Packing and shipping wages (Schedule II)	1,818.00	8,182.00	10,000.00
Shipping containers		800.00	800.00
Other shipping supplies	60.00	540.00	600.00
Delivery wages, supplies and expense		3,000.00	3,000.00
Newspaper advertising, including share of advertising salary (Schedule IV)	1,100.00	11,000.00	12,100.00
Display material and dealers' helps, including share of advertising salary (Schedule V)		3,050.00	3,050.00
Office and clerical salaries, office supplies and expense (Schedule VI)	1,376.00	5,224.00	6,600.00
Executive salaries	3,765.00	4,235.00	8,000.00
Bad debt allowance	240.00	1,350.00	1,590.00
	$224,159.00	$255,581.00	$479,740.00
Net income	$ 15,841.00	$ 14,419.00	$ 30,260.00

Schedule I

Warehouse depreciation, insurance etc.			$ 4,000.00
Apportioned on basis of space occupied by average inventory			
Restaurant line 200×30	6,000 cu. ft.		
Retail line 400×60	24,000 cu. ft.		
Total	30,000 cu. ft.		
Restaurant line (6/30 of $4,000.00)		$ 800.00	
Retail line (24/30 of $4,000.00)		3,200.00	
Total		$ 4,000.00	

Schedule II

Packing and shipping wages			$ 10,000.00
Apportioned on basis of $100.00 restaurant line sales equal 1 unit and $100.00 retail line sales equal 4 units.			
Restaurant line	2,400 units		
Retail line (2,700×4)	10,800 units		
	13,200 units		
Restaurant line (2/11 of $10,000.00)		$ 1,818.00	
Retail line (9/11 of $10,000.00)		8,182.00	
Total		$ 10,000.00	

Schedule III

Advertising salary		$ 1,650.00
Newspaper advertising—$\frac{2}{3}$	$ 1,100.00	
Display and dealer helps—$\frac{1}{3}$	550.00	
Total	$ 1,650.00	

Schedule IV

Newspaper advertising		$ 11,000.00
Advertising salary (Schedule III)		1,100.00
Total		12,100.00
Restaurant line—1/11	$ 1,100.00	
Retail line—10/11	11,000.00	
Total	$ 12,100.00	

Schedule V

Display material & dealer helps		$ 2,500.00
Advertising salary		550.00
Total		$ 3,050.00
Retail line	$ 3,050.00	

Schedule VI

Office and clerical salaries, office supplies and expenses			$ 6,600.00
	%	*Amount*	
(a) Keeping warehouse records	5	$ 330.00	
(b) Preparing orders and invoices	25	1,650.00	
(c) Posting sales invoices	15	990.00	
(d) Receiving and posting receipts	5	330.00	
(e) Preparing customers' statements	5	330.00	
(f) Credit and collection activities	10	660.00	
(g) General accounting & clerical	35	2,310.00	
Total		$ 6,600.00	

(a) Keeping warehouse stock records		$ 330.00
Apportioned to shipments—90%	$ 297.00	
Apportioned to receipts from factory—10%	33.00	
	$ 330.00	

Amount apportioned to shipments is allocated to the two lines on the basis of the number of entries (invoices×items):

Restaurant line (1,000×4)	4,000 entries
Retail line (9,000×12)	108,000 entries
Total	112,000 entries

Restaurant line (4/112 of $297.00)		$ 11.00		
Retail line (108/112 of $297.00)		286.00		
		$ 297.00		
Apportioned to receipts from factory			$ 33.00	
Restaurant line	10 items daily			
Retail line—50 items every other day equal to	25 items daily			
	35			
Restaurant line—2/7		$ 9.00		
Retail line—5/7		24.00		
		$ 33.00		

Summary

	Restaurant	*Retail*
Shipments	$ 11.00	$ 286.00
Receipts	9.00	24.00
Total	$ 20.00	$ 310.00

(b) Preparing order and sales invoice forms		$ 1,650.00
Apportioned on basis of items billed		
Restaurant line—4/112	$ 59.00	
Retail line—108/112	1,591.00	
Total	$ 1,650.00	
(c) Posting sales invoices		$ 990.00
Apportioned on basis of number of invoices		
Restaurant line—1/10	$ 99.00	
Retail line—9/10	891.00	
Total	$ 990.00	
(d) Receiving and posting cash receipts		$ 330.00
Apportioned on basis of number of invoices		
Restaurant line—1/10	$ 33.00	
Retail line—9/10	297.00	
Total	$ 330.00	
(e) Preparing customers' statements		$ 330.00
Apportioned on basis of number of customers		
Restaurant line—28/252	$ 37.00	
Retail line—224/252	293.00	
Total	$ 330.00	
(f) Credit and collection activities		$ 660.00
Apportioned one-half to checking orders and one-half to credit follow-ups		
Checking orders apportioned to the two lines on basis of number of orders		
Restaurant line—1/10	$ 33.00	
Retail line—9/10	297.00	
Total	$ 330.00	

Credit follow-up and collection apportioned on the basis of effort:

Restaurant line (1×28)	28
Retail line (5×224)	1,120
Total	1,148

Restaurant line (28/1148 of $330.00)		$ 8.00
Retail line (1120/1148 of $330.00)		322.00
Total		$ 330.00

Summary

	Restaurant	Retail
Checking orders	$ 33.00	$ 297.00
Credit follow-up and collection	8.00	322.00
Total	$ 41.00	$ 619.00
(g) General accounting and clerical		$ 2,310.00
Apportioned on basis of sales		
Restaurant line	$ 1,087.00	
Retail line	1,223.00	
Total	$ 2,310.00	

Summary of Schedule VI

	Restaurant	Retail
(a) Keeping warehouse stock records	$ 20.00	$ 310.00
(b) Preparing order and sales invoice forms	59.00	1,591.00
(c) Posting sales invoices	99.00	891.00
(d) Receiving and posting cash receipts	33.00	297.00
(e) Preparing customers' statements	37.00	293.00
(f) Credit and collection activities	41.00	619.00
(g) General accounting and clerical	1,087.00	1,223.00
Total	$ 1,376.00	$ 5,224.00

Solution to Problem 4 (*See opposite page*)

KEY TO ADJUSTMENTS

1. To write down land and buildings, $66,000.00, to reverse credit to premium account and to set up returned stock as unissued stock. The issuance of this stock was improper and the treatment accorded this item on the work sheet restores the stock to its original status.
2. To record the issuance of $60,000.00 par value stock for $25,000.00 and to adjust the "treasury stock" account.
3. The returned stock was not treasury stock and this entry is made to reverse the incorrect entry which was made in setting up "treasury stock" and the "stock donation" accounts.
4. To record depreciation for the current year on replaced machine.
5. To record loss on sale of machinery.
6. To charge new machine to asset account.
7. To record depreciation on balance of machinery (7½% of $144,000.00).
8. To record depreciation for the current year on buildings and to correct accounts for overstated charge in prior year.
9. To set up the ending inventories.
10. To increase the reserve for bad debts to 1% of the accounts receivable.
11. To charge operations for insurance expense.
12. To correct accounts for improper recording of sinking fund contribution and to record income on sinking fund investments.
13. To amortize bond discount for two years.
14. To record surplus appropriated for bond sinking fund reserve.
15. To adjust tax expense and accrued taxes accounts.
16. To record dividends declared.

Solution to Problem 4

YOUNG & CO., INC.

Working Trial Balance June 30, 1940

	Trial Balance (before adjustment) Dr.	Trial Balance (before adjustment) Cr.	Adjustments Dr.	Adjustments Cr.	Trial Balance (after adjustment) Dr.	Trial Balance (after adjustment) Cr.	Profit and Loss Dr.	Profit and Loss Cr.	Balance Sheet Dr.	Balance Sheet Cr.
Cash	$ 52,475.00				$ 52,475.00				$ 52,475.00	
Accounts receivable	320,000.00				320,000.00				320,000.00	
Reserve for bad debts		$ 650.00		(10) $ 2,550.00		$ 3,200.00				$ 3,200.00
Materials and goods in process—June 30, 1939	65,000.00				65,000.00		$ 65,000.00			
Finished Goods—June 30, 1939	158,000.00				158,000.00		158,000.00			
Insurance unexpired—June 30, 1939	3,000.00			(11) 1,500.00	1,500.00				1,500.00	
Land	200,000.00			(1) 26,400.00	173,600.00				173,600.00	
Buildings	300,000.00			(1) 39,600.00	260,400.00				260,400.00	
Reserve for depreciation of buildings		6,000.00		(8) 4,416.00		10,416.00				10,416.00
Machinery and equipment	148,500.00		(6) $10,000.00	(5) 4,500.00	154,000.00				154,000.00	
Reserve for depreciation of machinery and equipment		11,250.00	(5) 900.00	(7) 10,800.00 (4) 450.00		21,600.00				21,600.00
Reserve for replacements		15,000.00				15,000.00				15,000.00
Sinking fund trustee	25,000.00		(12) 25,000.00		50,000.00				50,000.00	
Discount on bonds	25,000.00			(13) 5,000.00	20,000.00				20,000.00	
Treasury stock	35,000.00		(2) 25,000.00	(3) 60,000.00						
Accounts payable		40,000.00				40,000.00				40,000.00
Bond interest accrued		3,125.00				3,125.00				3,125.00
Taxes accrued		9,000.00	(15) 2,250.00			6,750.00				6,750.00
First mortgage 5% sinking fund bonds		$226,250.00		(12) 23,750.00		250,000.00				250,000.00
Capital stock		500,000.00				500,000.00				500,000.00
Premium on capital stock		50,000.00	(1) 6,000.00 (2) 35,000.00			9,000.00				9,000.00
Stock donation		60,000.00	(3) 60,000.00							
Reserve for bond sinking fund		25,000.00		(14) $ 25,000.00		50,000.00				50,000.00
Surplus—June 30, 1939		60,000.00	(16) 50,000.00 (14) 25,000.00		15,000.00				15,000.00	
Sales, less returns and allowances		915,000.00				915,000.00		915,000.00		
Purchases of material	305,000.00				305,000.00		305,000.00			
Labor	132,800.00				132,800.00		132,800.00			
Operating expenses, repairs, etc.	121,500.00		(11) 1,500.00 (7) 10,800.00 (4) 450.00 (8) 5,208.00	(15) 9,000.00 (6) 10,000.00	120,458.00		120,458.00			
General expenses	17,500.00		(10) 2,550.00		20,050.00		20,050.00			
Bond interest	12,500.00		(13) 2,500.00		15,000.00		15,000.00			
	$1,921,275.00	$1,921,275.00								
Unissued stock			(1) 60,000.00	(2) 60,000.00						
Loss on sale of machinery			(5) 3,600.00		3,600.00		3,600.00			
1939 depreciation overstatement				(8) 792.00		792.00		792.00		
Inventories, June 30, 1940										
Materials			(9) 52,000.00		52,000.00				52,000.00	
Goods in process			(9) 105,000.00		105,000.00				105,000.00	
Finished goods			(9) 137,000.00		137,000.00				137,000.00	
Profit and loss				(9) 294,000.00		294,000.00		294,000.00		
Interest on sinking fund investments				(12) 1,250.00		1,250.00		1,250.00		
Amortization of bond discount—1939			(13) 2,500.00		2,500.00		2,500.00			
Taxes—1939			(15) 6,750.00		6,750.00		6,750.00			
Dividends payable				(16) 50,000.00		50,000.00				50,000.00
							$829,158.00	$1,211,042.00		
Net income							381,884.00			381,884.00
			$629,008.00	$629,008.00	$2,170,133.00	$2,170,133.00	$1,211,042.00	$1,211,042.00	$1,340,975.00	$1,340,975.00

Solution to Problem 5

Retail Method

When this method is used a record must be kept of both the cost and retail values of purchases, "mark-ups" and "mark-up cancellations," "mark-downs" and "mark-down cancellations." The inventory is taken at retail value and is reduced to cost, or a value lower than cost, by deducting from the retail value an amount determined by the percentage relationship of cost to original selling price plus "mark-ups." In this calculation "mark-downs" are ignored.

The method is used to advantage in department stores. It was probably adopted because of the more or less fixed relationship between wholesale and retail prices, and because of the relative ease with which the inventory could be taken and priced at retail.

It is an acceptable method for federal income tax purposes.

Base-Stock Method

The foundation of this method is the theory that the minimum or basic inventory of staple materials which must be carried as a reserve to enable the concern at all times to meet the needs of production or demands of customers is analogous to a fixed asset and should not be subject to price fluctuations. It is held that this "base stock" should be valued at a long-run "normal" price. The balance of the inventory, over and above this base or reserve stock, is priced at current costs. The method assumes that fluctuations in the value of normal inventory stocks from period to period have no bearing on operating success or long-run financial condition and, hence, should not be allowed to affect the income account.

This method has been disapproved by the Bureau of Internal Revenue.

Last-in, First-out

This method of pricing inventory is founded on the supposition that the most recently acquired merchandise is the first sold or put into production. As a result, the valuation of inventory from period to period would be the same if the quantities acquired were equal to the quantities sold or put into production.

The last-in, first-out method is used in the petroleum, leather, and nonferrous metals and other lines of industry whose product sales prices are influenced by the replacement rather than the historical cost of those products and whose inventory quantities are fairly constant. On this basis, in the case of a rising market, production will be charged with higher costs and inventory will be valued at the lower costs, thus creating a cushion against inflation of profit. On the other hand, in the case of a falling market, production will be charged with lower costs and the operating loss, if any, will not be as great. The use of this method tends to iron out the extremes of the profit and loss curve.

The last-in, first-out method is acceptable for Federal tax purposes.

Cost or Market

Cost or market is a valuation method which prices the individual items of an inventory at the lower of cost or market values. The method is designed to avoid the anticipation of profits and to provide for actual and possible losses.

GENERAL COMMENTS

Problem 1 is simple though the requirements are stated in such a way as to obscure the examiner's wishes. In part (a) of the problem the instructions are to ignore income-tax regulations; in part (b) the candidate is told to prove his work [the work of part (a)?] "by one compound jour-

nal entry" adjusting the records "to reflect the correct balances as revealed by the income-tax schedule." Are the income-tax regulations to be disregarded or not? Also it seems in order to ask how one may prove work by means of a journal entry.

Problem 2—this is inexcusable!

Problem 3 carries the heaviest weight of any of the problems of this section, yet it is the most uninteresting and least worthwhile problem to appear in the examination for some time. A correct solution of this problem will not prove the examinee's ability as an accountant.

Problem 4, while not a difficult one, is by all odds the best accounting problem of this group.

Problem 5 is a question which is very similar to one asked in the November, 1940 examination.

For some time now there has been discussion of the desirability of lengthening the C.P.A. examination from two to three days. Many have felt that the two-day examination did not afford sufficient opportunity to explore the whole field of accounting. This examination gives evidence that much remains to be done to produce a satisfactory two-day examination before launching the more ambitious program

BOOK REVIEWS

Foundation of Accounting. Alfred D'Alessandro. (New York: Longmans, Green and Company, 1941. Pp. xii, 622. $4.00.)

This elementary accounting textbook is designed to meet the needs of a one-year college course at the undergraduate level. It is not greatly different in the sequence of its development from many other such texts. The balance sheet is taken as a point of departure for a discussion of the income statement, the technical features of ledgers, journals, and accounts, and the periodic process of adjusting, closing and preparing statements This material constitutes approximately two-thirds of the text, excluding problem material, the remaining one-third being devoted to a discussion of manufacturing costs, partnerships and corporations.

While it is orthodox in its main outlines, the book is more limited in scope than most elementary accounting texts. For example, there is no discussion of specialized problems of revenue realization such as instalment sales or long-term contracts; the character and function of surplus reserves are scarcely touched; asset valuation problems are given scant attention; dividend problems are disposed of in one page, with no mention there, nor elsewhere, of stock dividends—in fact, stock dividends would be an impossibility if the author's statement were true that "On account of legal restrictions, the surplus or deficit of a corporation cannot be closed or transferred into the capital stock or accounts" (p. 375)

Perhaps more noticeable than the subjects omitted are the subjects that are incompletely presented. One of the striking examples is the complete avoidance of the term "earned surplus" in the section on corporation accounting. In the course of that discussion a single undifferentiated surplus account is presented. However, the possibility of a subdivision of surplus is explicitly recognized in the discussion of capital surplus, donated surplus, and appropriated surplus. But there is no discussion of earned surplus. In transactions where earned surplus is involved the author reverts to the use of the undifferentiated surplus account, although he does not do so with respect to transactions involving capital surplus. Another example is the presentation of the subject of statement analysis and interpretation in the second and third chapters of the book. While this arrangement is not wholly bad since it may arouse some student interest not otherwise captured, yet it does so at the price of the subject matter since, of necessity, much significant material must be omitted or inadequately developed at this early stage. Detailed enumertion of instances is not possible in this review but it is not unfair to say that there are many topics that seem inadequately explored. This limited scope is intentional since the author in his preface states that "beginning students find it very difficult to choose and discriminate effectively among several treatments."

It is presumably as a corollary to this idea that he avoids theoretical discussions almost entirely and centers his attention on form or technique. The proper emphasis to be given theoretical considerations in the first-year accounting course is always a difficult question of balance but the painstaking avoidance of theory throughout this book is difficult to justify. He mentions that "accounting teachers are all familiar with the complaint of students that they do not know where to start in solving problems which are not wholly mechanical in nature" (p. v). The difficulty is merely aggravated by an approach that is almost wholly mechanistic.

Another characteristic of the book is its reliance on the account as a medium of explanation. After introducing the account and the notion of double entry the author lists the more common balance sheet and income statement accounts, itemizes the customary debits and credits found in each and indicates the position it should occupy in the financial statements. The same method is adopted in developing the accounting problems involved in manufacturing costs, partnerships, and corporations. The method is not free from confusion. It is often not clear what credit should offset a described debit (and vice versa). More serious, however, was the fact that the same item was sometimes alternatively debited or credited to more than one account without adequate explanation or reconciliation. For instance, premiums on capital stock are listed as credits under three different accounts without any explanation of which treatment is preferable, or even why the alternatives exist. This example is not unique.

There are various procedures recommended by the author that are neither generally accepted practice nor theoretically sound. First, he recommends that profits and losses on the sale of fixed assets be recorded in capital surplus (p. 376). Also, he says that profit or loss on the sale of treasury stock may be "taken up through capital surplus, surplus, or *through an appropriate profit and loss account which will be shown in the profit and loss statement*" (p. 372, emphasis supplied). In discussing the valuation of accounts receivable he indicates that the provision made at the end of the accounting period for uncollectible accounts, anticipated sales returns and allowances, and anticipated sales discounts may be lumped into one debit called "loss from bad accounts and reserve for bad debts credited" (p. 118).

The author does little to dispel the troublesome notion that is so prevalent among beginning accounting students that the allowance for depreciation is a mysterious source of cash that will provide for the replacement of fixed assets. Such statements as "Depreciation is provided in order to have the concern recover the money spent in the asset" appear in several places (pp. 14, 126) without appropriate modification.

There were numerous instances throughout the book in which technical terminology was employed but not explained. For instance, in discussing income statement accounts there is repeated reference to the entry to be made "when the books are closed" but closing entries are not explained for another three chapters. The same criticism applies to the use of contingent liability (p. 116), control account (p. 154), surplus (p. 29), treasury stock (p. 365).

Problem material appears to be satisfactory. No long practice sets have been prepared to accompany the book.

E. B. RICKARD

Washington, D. C.

Advanced Accounting. W. A. Paton. (New York, The Macmillan Company, 1941. Pp. xx, 837. $5.00.)

Just as Professor Paton's *Essentials of Accounting* is no ordinary rehashing of accounting fundamentals, so his *Advanced Accounting* is in no sense the usual kind of intermediate or advanced text. The scope of work covered is somewhat different but, more important, the author has expressed himself for the first time, at least to a wide audience, on various controversial points of accounting about which there has been entirely too much loose writing if not loose thinking.

The average teacher of advanced accounting will no doubt be somewhat startled to find that the present volume contains no (or practically no) discussion of consignments, branch accounts, instalment sales, foreign exchange conversion, estates, or partnership accounting. Accounting for receivers in equity is approached through the statements and is treated briefly (pp. 108–113). When this volume is used in conjunction with *Essentials*, this "deficiency" is not particularly acute, since many of these topics are covered adequately in the earlier volume. With regard to estates, bankruptcy, and foreign exchange, it can be urged that they be deferred until a course in specialized accounting. Nevertheless, when *Advanced Accounting* is used in conjunction with somewhat elementary first-year texts, many teachers may find it desirable to introduce a one-semester intermediate course to cover some of these omissions and to prepare the students for the mature viewpoint necessary for an appreciation of the arguments advanced in this text.

The incisive, argumentative writing style which characterizes Mr. Paton's publications is particularly noticeable in *Advanced Accounting*. At the advanced level such a presentation is certainly to be desired, especially since business executives are more and more calling for accountants to justify their practices. The present work is singularly free of annoying statements which are obvious in themselves and of the frequent misstatements which one has come to expect in accounting texts. This is not to say that there are no statements to which the instructor may wish to take exception—there are many such issues and conclusions—but even in these cases the author outlines carefully the opposing points of view. Teachers who are well trained in economics will appreciate the broad economic view adopted by the author, while the unusual emphasis on the determination and measurement of periodic enterprise income will appeal to those who teach accounting as a branch of economics and also to those offering the course in schools of business administration.

For those who have followed the author's publications the treatment of consolidations is perhaps the most interesting section. With his usual disregard for traditional procedures Professor Paton argues that the elimination of intercompany profits in inventories should be not for the gross margin but for the net income element (pp. 794 and 796). The practical result (which some of us will no doubt find undesirable) is that certain administrative and selling costs are blocked from the current operating statement and included in the inventories. The defense for this somewhat unusual treatment must be based on a "substantive" difference in goods residing in the warehouses of separate corporate entities and in product in the storehouses of the controlling firm. Inasmuch as the avowed purpose of consolidated statements is to cut through the legal partitions, such a criterion for the shifting of operating net appears to rest on a precarious basis. The author argues further that an elimination in the opposite direction is indicated if the dominant corporation suffers an operating loss (p. 796). Most accountants must feel, with the reviewer, that blocking off current losses in the inventories, whether of the holding company or of its subsidiaries, is questionable accounting practice. Mutual ownership, and even mutual control, are treated fully (pp. 783–792) and attention is given to the knotty problems of dividends with mutual ownership. Where the inventories of the holding company contain goods shipped from partially owned subsidiaries, Mr. Paton recommends the elimination in both directions. This is one of the rare recommendations which are given without defense or extended comment. Since the usual advanced textbook outlines the three "acceptable" methods and ordinarily refrains from including satisfactory arguments relating to each, this omission is particularly unfortunate.

The last-in, first-out inventory procedure is discussed at length, and, as may be expected from the author's previous writings, a somewhat unfavorable verdict is rendered. This method is allied with "artificial stabilization" of periodic profit reports—a viewpoint, it should be observed, which is based on traditional definitions of income. The author points out that leveled profits may be expected, but sympathizers with last-in, first-out will be disappointed that the probable effects of this method on working capital administration, decisions to invest relative to construction costs, probable security price reactions, and the possible effect of general acceptance on the business cycle itself are omitted from the discussion.

Though the treatment is not sympathetic from the point of view of last-in, first-out, advocates of cost or market, whichever is lower, should be pleased that the caustic indictments of this venerable—but not too defensible—doctrine have been softened. For example, *Essentials* (p. 485) contains the following statement: " 'Cost or market, whichever is the lower,' notwithstanding its wide adoption in some form in practice, is an unscientific, illogical approach to inventory valuation, a fact which becomes very apparent when the effect on the periodic income report is considered." The present volume (p. 157) contains this statement: "A defense for the cost or market policy which is worthy of attention construes this policy as a means of implementing the thoroughgoing cost approach, rather than as a partial recognition of the market basis of valuation." Though this position is later criticized, the reader is left

with the feeling that the method is not completely ridiculous.

The rather complete treatment of depreciation, retirements, renewals, and other difficult problems of fixed asset "valuation" should be particularly pleasing to many instructors and practitioners. Group depreciation procedure and lapse schedules are given attention. As may be expected, periodic depreciation is interpreted as a means of spreading a sunk cost to the various periods. An entire chapter is devoted to depreciation in utility accounting, which deals almost entirely with the merits and shortcomings of retirement accounting and the possibility of "excessive" reserves in connection with straightline apportionment.

Considerable space, ninety pages, is devoted to statement analysis. In connection with the discussion of "common-dollar" reporting some attention is given to tracing the loss or gain in purchasing power arising from holding cash and obligations payable in cash during periods of changing price levels. Some mention is made of attempts to trace surplus utilization. While it is admitted that the assumptions by which surplus is correlated with classes of assets are questionable, such a breakdown has wide acceptance in institutional accounting and may have limited application to industrial statistics and accounting. The technique of profit analysis through variety, price, and quantity variations are omitted.

Students of accounting have come to expect significant contributions to theory and practice in the writings of Mr. Paton. In this respect readers of *Advanced Accounting* will not be disappointed.

CARL DEVINE

The University of Kansas City

Elementary Cost Accounting. George Hillis Newlove and S. Paul Garner. (Boston: D. C. Heath & Co., 1941. pp. x, 557. $4.00.)

This text is a distinct improvement over its predecessor written by the senior author in 1928. It has been largely rewritten with much new material added. In the light of extended classroom experience in the interim and the fresh viewpoint of a co-author the emphasis has been shifted considerably, though not enough, from the "how" (debit this and credit that) to the "why" approach. The review questions at the end of each chapter have been omitted. They will be missed by many students and teachers alike. Much of the practice set and many of the problems have been carried over intact or with slight modification. Of the new problems a large number are adaptations from C.P.A. examinations.

The aim expressed by the authors is to give a basic grounding in cost accounting in a single course to students who have had one or more elementary accounting courses. The content of the book, although it gave recognition to the opinions of several hundred accounting instructors, is for the most part fairly conventional.

In the introductory chapter general accounting for a factory is presented and the need for more detailed cost data is shown. A general outline is then given of what the providing of these additional data requires. The Cost Ledgers, Journals and Factory Orders are next discussed. The forms of the various journals and detailed instructions for posting from each of them are given even for the Cash Receipts, Cash Disbursements and Sales Journals which are identical with the corresponding journals in a non-cost system.

The third, a long chapter, treats Subsidiary Cost Ledgers and Records. Here not only the skeleton framework but also a considerable filling-in is presented. As a result, subjects (Burden Incurred, Burden Applied) accounts with detailed listings of the various items debited and credited to them (Materials and Supplies, p. 47, Work in Process p. 54, Material to be Salvaged, p. 66, and Burden Incurred, p. 73) and forms (Purchase Order, Material Rejected Report, Material or Component Parts Requisition, Material Received Report, Time Ticket, Defective Work etc.) are introduced but the full explanation of them comes much later in the text.

After this presentation of the cost-accounting records for a Job Order system the accounting for the three cost elements, Raw Materials, Labor and Burden is taken up in order. Four chapters are devoted to the treatment of Burden, its control collection, departmentalization, application to the product, and its problems under abnormal conditions.

Process Costs are covered briefly but adequately for an elementary course, in two chapters. Following this are a number of special chapters:

Accounting for Scrap, Salvaged Goods, By-Products and Co-Products
Class, Assembly and Foundry Costing
Inventory Difficulties and Complexities
Distribution Costs
Cost Reports, Summaries, and Control
Elements of Standard Cost Accounting

The authors believe that this last subject is not properly a part of an elementary cost-accounting course. However, in deference to the majority opinion of accounting instructors a brief treatment of Standard Costs is included as Appendix A.

At the end of the text material there are, classified according to chapters, a series of Exercises (89 of them) and Problems (39) and a Model Practice Set (Job Order) which takes the place of problems for chapters four through eight.

Every teacher and every writer is beset by the problems of prerequisites, sequences and adequacy of treatment of his subject. Of the hundreds of such decisions that must be made in a book of this kind there are of necessity a number with which any reviewer would disagree. For example, the use of the Burden Applied account in the introductory chapter, when the discussion of the subject of Burden is deferred to Chapters 6–9 would seem to the reviewer to confront the student with an unnecessary difficulty at the outset. Together with most of the recent books on the subject this text takes up Job Order before Process cost accounting. Many instructors no doubt feel that the unfolding of the subject proceeds more logically from non-cost fac-

tory accounting to Process and than to Job Order cost accounting.

The typical debits and credits to various accounts, for example, the Burden Incurred account on p. 73 will by its completeness please those using the book as a reference but the 14 typical debits and 7 typical credits may overwhelm a student that has barely gotten into the subject. In a number of places the repetition and near repetition, though excellent for aiding the student in the learning process, seems to have been overdone.

Taking the book as a whole the authors have produced a worthwhile addition to the elementary cost-accounting literature. They have gone to great pains to be explicit, making liberal use of flow charts, charts of interrelated forms, and illustrative solutions to typical problems. Unusual and welcome are:

A chapter on Inventory Difficulties and Complexities
A chapter on Burden under Abnormal Conditions
The inclusion of problems and their solution in the body of the text material
Frequent quotations of investigations indicating actual current practice.

H. J. Rehn

Temple University

Bookkeeping and Accounting. Fourth edition. Arthur H. Rosenkampff and William C. Wallace. (New York: Prentice-Hall, Inc., 1941. Pp. xix, 349. $1.60.)

The purpose of this text is to furnish material for a sound course in bookkeeping and accounting at the secondary school level. It contains no tedious practice sets, the three which are included being of the short type. The use of business papers and forms is optional with the first practice set. More exercises and drill material are found in this fourth edition than in the earlier ones.

The general plan of this edition follows that offered in the previous ones, although some of the chapters are, said to be broken down into smaller teaching units and a chapter on Social Security bookkeeping has been added.

The subject is approached from the financial statements—the balance sheet and the profit-and-loss statement—and from here the material leads into a study of ledger accounts, eleven chapters out of twenty being allotted to them.

This book was accorded considerable success in its earlier editions, and no reason seems apparent to suggest that the present one cannot go much farther than the others. The language is simple, the illustrations are clear, and the student is led along almost as carefully as one would lead a blind man along the crowded city thoroughfare.

After pointing out the objects and fundamental elements of bookkeeping, the two usual statements are taken up. After this, one studies the account in relation to these statements, then the merchandise account and its subdivision, accounts for credit transactions, notes, expense and income accounts, journals, interest, the use of special-columned books, closing entries, and again the statements. Following this, are chapters on business practice and forms, accruals, and Social Security.

The paper seems of good quality, and the printing is sufficiently large so that eye strain is avoided.

The methods available for the study of bookkeeping are many, and, fundamentally, whether one is better than others is only a matter of personal opinion and current fashion. The test of a book of this kind is whether or not it is teachable; and the answer is in the affirmative.

If one favors the approach here used, or is willing to consider with an open mind, he need not hesitate to acquaint himself with the material offered. The theory phase of the subject seems orthodox in every way.

George E. Bennett

Syracuse University

New York Corporation Laws, 1941. Annotated, Revised to May 3, 1941. (New York: United States Corporation Company. Pp. xxxii, 567. $2.00.)

This book is another annotated edition of a popular and exceedingly useful book for accountants as well as for lawyers, in that it includes the legislation and decisions in this state relating to the organization, operation, and regulation of private business corporations. This revision carries down to May 3, 1941, thus including all changes affected by the Legislature adjourned just prior to such date.

The changes made, and all of them seem substantial, consist of numerous separate enactments amending, repealing, or adding some 50 separate sections of the statutes which appear in the publication. Of these, at least 45 are of major importance.

The volume contains liberal annotations of judicial decisions. The synoptic analysis of previous editions—a rather unique piece of work—is in this edition also. This is a topical arrangement of the general corporation law, of the stock corporation law, of the corporation tax laws, and of the relationship of the several corporation laws to each other.

Having pointed out briefly just what this book contains, and after suggesting time and again that reference to the various editions is essential if corporate entries and accounts are to be prepared properly, it seems strange, at least to this reviewer, why accounting teachers within New York's jurisdiction should hesitate to familiarize themselves with what is contained in each new edition—if they are at all interested in doing a good job with their teaching.

George E. Bennett

Syracuse University

Farm Accounting. Donald R. Mitchell. (New York: McGraw-Hill Book Company, 1941, Pp. x, 231. $2.50.)

A real pleasure was afforded by the opportunity given to examine, read, and criticize this book in this its first edition.

A number of years has elapsed since this reviewer was called upon to audit the accounts of, and then to revamp the system for, a mid-West farming enterprise

of considerable size. Life at such time would have been much more cheerful and sweeter than it was, if a book of this type had been available.

It does not seem possible to consider the author as a finished accountant. A number of terms are used in a slightly incorrect manner, but inasmuch as those for whom the book is intended are not expected to become accountants and auditors, such inaccuracies may be overlooked without hesitation.

The reviewer cannot agree with the author in his presentation of the basic equation—that regardless of the presence of liabilities this equation is merely that assets equal capital. Liabilities are just asset offsets. Carried to a conclusion one should subtract liabilities from related assets on the left side of the balance sheet and show the right side merely as capital.

On the other hand, a reading of certain sections of this book by many who consider themselves the last word in accounting theory might start a train of thought which would tend to bring them back to earth so that they really could benefit our wonderful science of accounting with brilliant ideas of a solid, substantial, and back-to-earth application. Such, in the opinion of the reviewer, is chapter 2, on the subject of farm inventories. The ideas of this chapter would be worth while while included in any book on accounting fundamentals in which inventories and fixed assets are discussed.

The text contains 25 chapters plus an appendix. One chapter is a model set, and three more are practice sets. The remainder is given over to text matter, this being considered under the following arrangement:

Double-entry bookkeeping
Farm inventories
The classification and numbering of accounts
The journal
The ledger
Depreciation in farm accounting
Special journals
Capital and revenue
The purpose of adjustment accounts in farm bookkeeping
Prepayments and accruals
Notes and interest
Unusual losses on the farm
Partnership accounting on the farm
The farm family and its relation to the farm business
The cash journal
The work sheet
Setting up the accounting system.
The interpretation of financial records
Non-financial farm records.
The factor method of farm business analysis

In short, regardless of its faults, the book may be studied with profit by many who are not, and never expect to be, farmers. It is good!

GEORGE E. BENNETT

Syracuse University

Public Administration Organizations: A Directory, 1941. (Chicago: Public Administration Clearing House, 1941. Pp. x, 187. $1.50.)

This is the fifth edition of the directory, the first having been published in 1932. Taken as a whole the five editions record the growth and present status of professionalism in the public service, and they also indicate the great and growing interest of nation-wide groups of private citizens in the activities and standards of public officials. The first edition listed 1,744 organizations, while the present volume shows an expansion to 1,905 in spite of a shrinkage of state organizations.

Only organizations which are voluntary or unofficial in character are included and only those at least statewide; apparently no one has attempted the task of listing local organizations in this field, whose number is probably great. The national, state and regional groups listed are placed in one of the following categories: (1) Organizations of or for public officials; (2) Professional and technical societies; and (3) Citizen organizations. They thus include groups formed primarily for their economic advancement and protection and those lay groups devoting attention to "some phase of public administration or to problems which are of concern to some public officials" (pp. vii–viii). The most complete descriptive material is limited to national organizations, 556 in number, which have also been classified by fields of activity. Thus under ACCOUNTING are listed the American Accounting Association (publishers of the *Review*), the American Institute of Accountants, the National Association of Cost Accountants, and the National Committee on Municipal Accounting. Other organizations of interest to the accounting profession are listed under FINANCIAL ADMINISTRATION, TAXATION, and ECONOMICS AND BUSINESS. It is interesting to note that the classifications which include the greatest number of national organizations are in order EDUCATION (35), PUBLIC WELFARE (33), and PUBLIC HEALTH (30).

J. HAROLD DENIKE

University of Cincinnati

One Hundred Short Problems in Corporation Finance. Revised Edition. Herbert E. Dougall, Harold W. Torgerson. (New York: The Ronald Press Company, 1941. pp. viii, 135. $.90.)

This series of problems is compiled to illustrate the basic principles of corporation finance as they are presented in the standard texts in that field. The materials cover a wide range of topics dealing with organization and control, stocks and bonds, promotion, capitalization, marketing of securities, current financing, net income, expansion and combination, refinancing, and reorganization.

The problems are presented in such a manner as to acquaint the student with the newer devices in corporation finance and to refer him to recent legislation and standard sources in the field. A considerable portion of the material directs attention to the accounting aspects of corporate finance but the very nature of modern corporate practice makes such emphasis not only desirable but inevitable.

The "problem method" as presented in this volume should serve as a very useful tool in teaching corporation finance.

PAUL R. OLSON

State University of Iowa

UNIVERSITY NOTES

HARRY D. KERRIGAN

UNIVERSITY OF CALIFORNIA AT LOS ANGELES

Mr. Karrenbrock is offering a new course entitled "Municipal and Governmental Accounting."

I. N. Frisbee is on leave during the current semester to collect data for a text on auditing.

UNIVERSITY OF CINCINNATI

The evening college is presenting two courses on defense accounting.

Mr. Holmes' auditing book is being translated into Spanish for distribution in Latin American countries.

N. G. Geis was made a member of the committee on press and publicity of the Ohio Society of C.P.A.'s.

In accordance with a work-and-study scheme now in operation, upperclassmen work in public accounting for a seven-week period, return to their classes for a corresponding period, and repeat the process until they graduate. Cincinnati and Dayton firms are cooperating in this plan. A given position is occupied by a different student every seven weeks; usually, the same two students alternate in filling a particular position.

UNIVERSITY OF DENVER

A work-and-study plan has been adopted this year whereby students will work for public accountants from December 15 to March 30. Although employed full time during this period, students remain under the supervision of a faculty member, are required to do collateral reading, and must report from time to time to their faculty supervisor.

HARVARD GRADUATE SCHOOL OF BUSINESS ADMINISTRATION

E. K. Crotsley, instructor in accounting, has accepted a position with St. Lawrence University as assistant professor and controller.

Arriving recently as visiting lecturer from the University of Iowa W. J. Burney will be on leave from that school for the year 1941–42.

R. S. Claire, assistant professor of accounting, has been granted the Massachusetts C.P.A. certificate.

As chief of the cost-analysis section of the division of purchases of OPM, R. H. Sanders will divide his time between teaching at the business school and work in Washington.

UNIVERSITY OF IOWA

H. B. Eversole of the faculty has been elected president of the Iowa Society of C.P.A.'s.

At the October meeting of the society, Mr. Winter conducted a round table on accounting principles.

G. P. Maynard has been added to the staff as instructor in accounting.

LOUISIANA STATE UNIVERSITY

Mr. Saliers addressed a recent meeting of the Louisville, Ky., chapter of the American Society of Mechanical Engineers, on the subject "The Engineer's Responsibility for Depreciation."

Dr. C. T. Devine has resigned to accept a position with the University of Kansas City.

New instructors in accounting are: P. M. Jones, R. Ashmen, and G. L. Hodge.

MIAMI UNIVERSITY

W. H. Whitney has been appointed chairman of the committee on education of the Ohio Society of C.P.A.'s.

MONTANA STATE UNIVERSITY

Dr. A. P. L. Turner has returned to his duties after a leave of absence.

COLLEGE OF THE CITY OF NEW YORK

The accountancy department lost three members recently through death: S. A. Cash, instructor; L. M. Saxton, associate professor; and G. M. Brett, who had been associated with the school since 1906.

Recent publications have included the following: "Office Management and Practices" by Neuner and Haynes (Southwestern Publishing Co.); "Financial Statement Analysis" by J. N. Myer (Prentice-Hall Co.).

The Accounting Forum, a publication of the Accounting Society, composed of students and faculty, is enjoying a very large circulation. The magazine is under the direction of Mr. Neuner.

THE UNIVERSITY OF OKLAHOMA

Mr. V. L. Shelton of the staff was awarded an M.A. degree by the State College of Washington.

His thesis topic was "The Development and Use of the Statement of Application of Funds."

University of Oregon

The following change in instructors has taken place: O. R. Anderson has left the staff and D. K. Griffith has been added.

University of Pennsylvania

O. J. Curry, formerly acting dean of the School of Business, University of Arkansas, has been appointed associate professor of accounting.

University of Pittsburgh

Two instructors, both C.P.A.'s, have joined the staff: V. E. Bennett and J. F. Woessner.

University of Southern California

The third annual accounting institute was held on the campus, November 13, 1941. A general session in the morning, several round tables in the afternoon, and an evening meeting, including dinner, made up the program. Speakers and leaders numbered over thirty.

University of South Dakota

The Bureau of Business Research has recently been expanded. It now issues a monthly bulletin.

University of Texas

P. J. Graber, associate professor of accounting at the Oklahoma A. and M. College, is serving this year as visiting associate professor. G. W. Lafferty has resigned to accept the position of assistant auditor of the state of Texas.

Texas A. and M. College

H. A. Dulen of the staff was recently awarded a C.P.A. certificate.

The Houston chapter of the N.A.C.A. is conducting a prize contest open to accounting students and involving papers on a cost subject.

The Texas C.P.A.'s are arranging for another series of accounting institutes for the current year.

Wayne University

R. Wixon, instructor in accounting, is on leave to complete work for the doctorate at the University of Michigan.

INDEX VOLUME XVI

ARTICLES

His thesis topic was "The Development and Use of the Statement of Application of Funds."

UNIVERSITY OF OREGON

The following change in instructors has taken place: O. R. Anderson has left the staff and D. K. Griffith has been added.

UNIVERSITY OF PENNSYLVANIA

O. J. Curry, formerly acting dean of the School of Business, University of Arkansas, has been appointed associate professor of accounting.

UNIVERSITY OF PITTSBURGH

Two instructors, both C.P.A.'s, have joined the staff: V. E. Bennett and J. F. Woessner.

UNIVERSITY OF SOUTHERN CALIFORNIA

The third annual accounting institute was held on the campus, November 13, 1941. A general session in the morning, several round tables in the afternoon, and an evening meeting, including dinner, made up the program. Speakers and leaders numbered over thirty.

UNIVERSITY OF SOUTH DAKOTA

The Bureau of Business Research has recently been expanded. It now issues a monthly bulletin.

UNIVERSITY OF TEXAS

P. J. Graber, associate professor of accounting at the Oklahoma A. and M. College, is serving this year as visiting associate professor. G. W. Lafferty has resigned to accept the position of assistant auditor of the state of Texas.

TEXAS A. AND M. COLLEGE

H. A. Dulen of the staff was recently awarded a C.P.A. certificate.

The Houston chapter of the N.A.C.A. is conducting a prize contest open to accounting students and involving papers on a cost subject.

The Texas C.P.A.'s are arranging for another series of accounting institutes for the current year.

WAYNE UNIVERSITY

R. Wixon, instructor in accounting, is on leave to complete work for the doctorate at the University of Michigan.

INDEX VOLUME XVI

ARTICLES

CONTRIBUTORS OF ARTICLES

Harold G. Avery is Associate Professor in Business Administration and Economics at Bradley Polytechnic Institute, Peoria, Illinois.

Willard C. Beatty is Associate Professor of Economics at Brown University.

Russel Bowers has taught accounting in the University of Toledo, Butler University, and the University of Michigan. He has attended Miami University, the University of Illinois, and has a Ph.D. degree from the University of Michigan. He is now teaching Economics in Port Huron Junior College, Michigan.

Richard A. Byerly is a statistician and rate-analyst residing in Bloomington, Illinois.

Carl Devine, who recently secured his doctor's degree in Business Administration from the University of Michigan, is an instructor in Accounting at the University of Kansas City.

Robert L. Dixon is Assistant Professor of Accounting in the School of Business at the University of Chicago. At the Annual Meeting of the American Accounting Association in 1940 Professor Dixon was elected Secretary-Treasurer of the Association.

Alex Eisenstein is a member of the staff of Seidman & Seidman, New York City, and a teacher of Accounting in City College, New York.

Harold A. Eppston is attorney and counselor-at-law of New Jersey and a Master in Chancery. He has been a Trustee of the New Jersey Society of Certified Public Accountants and is now its first vice-president.

Louis O. Foster is Associate Professor of Business and Economics at Western Reserve University, Cleveland, Ohio. He is author of a textbook, recently published, in which the ideas expressed in his article have been incorporated.

Bruce Futhey is on the faculty of the School of Commerce and Business Administration of the University of Alabama.

H. C. F. Holgate, Ph.D., B.Sc.Econ., is a corporate accountant well-known in England for his books and articles on Accounting and Banking topics.

Ralph C. Jones is Associate Professor of Accounting at Yale University.

Wilbert G. Katz is Dean of the University of Chicago Law School. His article was originally published in the April issue of the University of Pennsylvania Law Review and was reproduced with the consent of the editor of that Journal.

Arthur C. Kelley is Associate Professor of Accounting at San Jose State College, San Jose, California.

Harry D. Kerrigan is Assistant Professor of Accounting at Northwestern University.

Edward A. Kracke is a member of the firm of Haskins & Sells. In 1938 and 1939 he served as one of the advisers of the Treasury Department in connection with the revision of the inventories section of the Federal income-tax law.

Willis Leonhardi is connected with the Chicago office of Arthur Andersen & Co.

A. C. Littleton is Professor of Accounting at the University of Illinois and co-author of the Association's most recent monograph.

Arthur N. Lorig, of the School of Business of the University of Washington, presented his paper at the Annual Meeting of the American Accounting Association in December, 1940.

Reuel I. Lund is instructor in Accounting and Economics at the University of Minnesota, having received his doctor's degree from that institution in 1940.

T. Leroy Martin, who obtained his Ph.D. degree at Harvard University in 1939, is teaching at The Bentley School of Accounting, Boston, Massachusetts. He was formerly instructor in accounting, Washington State College, and Assistant Professor of Accounting, University of Wisconsin. His article is a chapter from his doctoral dissertation, *Some Economic Aspects of Corporation Accounting*.

R. K. Mautz is instructor in Accounting at the University of Illinois and is now working on a doctoral dissertation.

Richard N. Owens is Professor of Accounting and Business Administration at George Washington University, Washington, D. C.

Earl A. Saliers is Professor of Accounting at the College of Commerce of Louisiana State University. The material contained in Dr. Saliers' paper represents the conclusions reached in an accounting seminar which he recently concluded.

DR Scott is Professor of Accounting, School of Business and Public Administration, University of Missouri.

H. T. Scovill, a former President of the Association, is head of the Department of Business Organization and Operation at the University of Illinois.

Frank P. Smith is Assistant Professor of Economics at the University of Rochester. He presented his paper at the 1940 Annual Meeting of the Association.

Richard E. Strahlem was formerly State Statistician of Indiana. He is now instructor in Accounting at Purdue University and is author of a text, "Accounting Fundamentals for Engineers" which will be published shortly.

Herbert F. Taggart is Professor of Accounting at the University of Michigan and is associated as a consultant with the Office of Price Administration, Washington.

J. R. Taylor is Assistant Professor of Accounting at the University of Tennessee; he was formerly instructor of Accounting at the University of Illinois.

Irving Tenner is on the staff of the Municipal Finance Officers' Association and edited that Association's recent publication on terminology.

William Underwood teaches Social Science at the Edison Institute, Dearborn, Michigan.

William W. Werntz is Chief Accountant of the Securities and Exchange Commission.

E. B. Wilcox has been a member of the firm of Edward Gore & Co., Accountants, since its organization in 1927. He is a former member of the Illinois C.P.A. Board of Examiners and was President of Illinois Society of Certified Public Accountants in 1939.

Sidney G. Winter, Professor of Accounting at the University of Iowa and former President of the Association, headed a roundtable dealing with accounting instruction at the Annual Meeting of the American Institute of Accountants in 1940.

Basil S. Yamey is a lecturer in the Department of Commerce, Rhodes University College, Grahamstown, South Africa.

Thomas York, now deceased, was associated in an editorial capacity with the Ronald Press Company. His paper was presented at the Annual Meeting of the Association in 1940, a few weeks before his death.

John H. Zebley, Jr. is a partner in the accounting firm of Turner, Crook & Zebley, Philadelphia, Pennsylvania. He is a Pennsylvania C.P.A. and has been a member of the Institute's Board of Examiners since 1936.

BOOK REVIEWS

AMERICAN ACCOUNTING ASSOCIATION
TWENTY-SIXTH ANNUAL MEETING

December 29-30, 1941
Hotel Astor, New York, N.Y.

PROGRAM

FIRST SESSION, MONDAY, DECEMBER 29, 9:30 A.M. to 4:30 P.M.
CHAIRMAN: E. L. Kohler, Chicago, Illinois

TOPIC: Accounting Principles Underlying Corporate Financial Statements
PAPER: "The Cost Principle," Walter A. Staub, Lybrand, Ross Bros. & Montgomery, New York, N.Y.
Discussion by W. A. Paton, University of Michigan

PAPER: "The Revenue and Income Principles," James L. Dohr, Columbia University
Discussion by Howard C. Greer, Kingan & Co., Indianapolis, Indiana

PAPER: "The Capital Principle," Samuel J. Broad, Peat, Marwick, Mitchell & Co., New York, N.Y.
Discussion by William W. Werntz, Securities and Exchange Commission, Washington, D.C.

SECOND SESSION, MONDAY, DECEMBER 29, 6:30 P.M.

Dinner and Business Meeting
Reports of Officers and Committees
Election of Officers

THIRD SESSION, TUESDAY, DECEMBER 30, 9:30 A.M.
ROUND TABLES

TOPIC A: Accounting Principles

CHAIRMAN: A. C. Littleton, University of Illinois

This round table is scheduled to give members an opportunity to discuss the recent statement by the Executive Committee, "Accounting Principles Underlying Corporate Financial Statements." Speakers at the first session will be present to participate in this discussion.

TOPIC B: Examinations
CHAIRMAN: E. A. Heilman, University of Minnesota

PAPERS: "The Use of Objective Examinations in Elementary Accounting," R. C. Dein, University of Minnesota

"Examination Techniques and Methods in Advanced Accounting," N. L. Burton, University of Buffalo

"The Standard C. P. A. Examination as Developed by the American Institute of Accountants," John H. Zebley, Jr., Chairman, Board of Examiners, American Institute of Accountants

FOURTH SESSION, TUESDAY, DECEMBER 30, 2:00 P.M.
ROUND TABLES

TOPIC A: Cost Accounting Problems Arising Out of the Defense Program
CHAIRMAN: Herbert F. Taggart, Office of Price Administration, Washington, D.C.

PAPERS: "Problems of Cost Accounting Instruction in Connection with the Emergency Training Program," S. P. Garner, University of Alabama

"Cost Accounting Problems in Connection with Price Control," Martin L. Black, Jr., Office of Price Administration, Washington, D.C.

"Cost Accounting Problems in Connection with Government Contracts," Lieutenant Commander Hermann C. Miller, U.S.N.R.

TOPIC B: Federal Accounting
CHAIRMAN: Fayette H. Elwell, University of Wisconsin

PAPERS: "The Execution of the Federal Budget," J. Weldon Jones, Bureau of the Budget, Washington, D.C.

"The Role of Accounting in the Administration of the Affairs of the United States Government," E. F. Bartelt, Commissioner of Accounts and Deposits, United States Treasury Department, Washington, D.C.

"The Audit Function in the Federal Government," Joel Hunter, Jr., Atlanta, Ga.

"Financial Reports of the Federal Government," Lloyd Morey, University of Illinois

COST ACCOUNTING IS DRAFTED FOR DEFENSE TRAINING COURSES

PERHAPS you haven't thought of cost accounting as a vital part of the defense effort. . . . But the United States Engineering Defense Training Program stresses cost accounting as an essential factor in keeping the wheels of industry in motion, in stepping up production to unprecedented levels, and in meeting the growing problems of wartime management.

Lawrence's COST ACCOUNTING leads again

Significantly, leading institutions, such as the University of California and the Pennsylvania State College, have adopted COST ACCOUNTING (Revised) by W. B. Lawrence in their defense courses.

Once before, this famous text was drafted, having been used in the original edition as a standard in the codification of American industry under the N.R.A. For its treatment is basic, covering the fundamental procedures upon which every system depends.

The International Authority

Now in its seventeenth large printing, COST ACCOUNTING has been taught in more universities, used by more governments and translated into more languages than any other book in this field. This semester, more than one hundred colleges and universities have adopted it.

Intensely practical

The practical treatment makes the text especially suitable for defense courses. The author, one of the pioneers in this field, has handled assignments involving millions of dollars. Every step, from the many illustrative entries to the problems and practice set, trains the student in the procedures he must use.

For regular or defense courses, make your teaching more effective and enjoyable with Lawrence's COST ACCOUNTING (Revised).

598 pages $4.00 list

A 1-volume, 1-year text in accounting principles

GENERAL ACCOUNTING

By H. A. Finney, C.P.A.

At last a streamlined text especially suitable for defense courses for engineering and other students who must quickly acquire a thorough grounding in accounting fundamentals. $4.00

PRENTICE-HALL, INC.
70 Fifth Avenue, New York